NOTES

VALUATION OF ASSETS TO DETERMINE DIVIDEND LEGALITY —THE BUSH TERMINAL CASE*

THE guiding principle of American dividend law for 115 years,[1] designed to protect stockholders and creditors,[2] has been to retain intact in the business the amount of assets contributed by the stockholders. Despite the longevity of the standard, the method of valuation upon which the continued presence of these assets in the business is to be determined has scarcely been litigated. For the most part it has been assumed that the balance sheet prepared by accountants in accordance with sound accounting principles reveals whether the company's assets exceed its liabilities by the amount of stockholder investment.[3] Yet this accounting statement is couched in terms of original, historical costs; it does not pretend to indicate whether sufficient

* Randall, as Trustee of Bush Terminal Company, Debtor v. Bailey, N. Y. L. J., Oct. 29, 1940, p. 1309, col. 6 (Sup. Ct. Oct. 24, 1940).

1. Wood v. Dummer, 30 Fed. Cas. 435, No. 17,944 (C. C. D. Me. 1824); see Kehl, *The Origin and Early Development of American Dividend Law* (1939) 53 HARV. L. REV. 36. Statutes and cases are discussed in Ballantine and Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws* (1935) 23 CALIF. L. REV. 229; Weiner, *Theory of Anglo-American Dividend Law: The English Cases* (1928) 28 COL. L. REV. 1046; Weiner, *Theory of Anglo-American Dividend Law: American Statutes and Cases* (1929) 29 COL. L. REV. 461; Weiner, *The Amount Available for Dividends Where No-Par Shares Have Been Issued* (1929) 29 COL. L. REV. 906; Weiner and Bonbright, *Theory of Anglo-American Dividend Law: Surplus and Profits* (1930) 30 COL. L. REV. 330, 954; Comment (1940) 49 YALE L. J. 492. See also Buchanan, *Theory and Practice in Dividend Distribution* (1938) 53 Q. J. ECON. 64.

2. For a discussion of the interests of creditors, stockholders, and management in the payment of dividends, see Comment (1940) 49 YALE L. J. 492-495. Short-term creditors are particularly interested in preservation of an equivalent amount of corporate assets as general security for payment of their debts. Long-term creditors, especially unsecured creditors, are concerned to keep liquid corporate assets required as working funds of the business from dissipation among stockholders. For preferred stockholders the danger is that their contribution to corporate capital may be distributed to common stockholders. And common stockholders, who possess theoretical control of the corporation, require protection against return of part of their original investment in the guise of surplus earnings, which will be treated as a recurrent type of spendable income. Most important, for creditors and stockholders alike, is the possibility that, under a system of absentee ownership, an unchecked management through unwise distributions may so threaten the financial soundness of the enterprise as to lead to insolvency. See DEWING, FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934) 606-667; *cf.* BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) 119-125. In contrast to the need for protection of these interests there is the general belief that the considerations of good financial management which should determine the question of a dividend payment are much too complex to be confined within the strait-jacket of statutory or judicial rules.

3. The scattered decisions are reviewed in 2 BONBRIGHT, VALUATION OF PROPERTY (1937) 920; REITER, PROFITS, DIVIDENDS AND THE LAW (1926) 87 *et seq.*; Briggs, *Asset Valuation in Dividend Decisions* (1934) 9 ACCOUNTING REV. 220.

assets remain if current valuations are employed.[4] Since the protection afforded depends upon current worth, the absence of any attempt to determine legality of dividends by current valuations is surprising. The decision in favor of current valuations in the recent *Bush Terminal* case[5] in New York threatens to recast all previously litigated concepts of the basis for determining the legality of dividends.

Plaintiff, as trustee under Section 77B for the Bush Terminal Company, sued former directors of the company to recover $3,639,000 in dividends on debenture stock and common stock which plaintiff alleged had been paid illegally from 1928 to 1932. The books of the Terminal Company showed a surplus during each of the years in question, varying from $4,378,000 at the end of 1927 to $2,199,000 in 1932, but plaintiff contended that improper valuations had been made upon the books in arriving at surplus available for dividends. The principal items attacked were a goodwill asset of $3,000,000 originally set up in 1905, unrealized appreciation of $7,211,000 resulting from writeups of real estate in 1915 and 1918, and the book value of investments in certain subsidiary companies which it was claimed exceeded actual value by amounts varying from $2,638,000 in 1927 to $3,370,000 in 1932. In his contention, plaintiff relied on the argument that "value" in the dividend statute[6] meant value as determined by accounting procedure.[7] Defendants,

4. See discussion *infra* pp. 312-313. Compare 2 BONBRIGHT, VALUATION OF PROPERTY (1937) 898 *et seq.* with CANNING, THE ECONOMICS OF ACCOUNTING (1929) c. 8. Accounting, according to Bonbright, views the valuation of assets as merely an incident in the determination of income. The formal procedure of accounting has misled economists and judges into a two-fold error based on the belief that the accountant ascertains the profits of a business by measuring the increased net worth of the enterprise, and that in the process he determines the real worth of the assets. See Lubbock v. British Bank of South America, [1892] 2 Ch. 198; Seligman, *Income Tax*, in 7 ENCYC. SOC. SCIENCES (1932) 626, 628-629; MEAD, CORPORATION FINANCE (6th ed. 1930) 252. The accounting profession is somewhat to blame for this misunderstanding. But *cf.* SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 55-58; see Sanders, *Accounting Aspects of the Securities Act* (1937) 4 LAW & CONTEMP. PROB. 191, 195.

5. Randall, as Trustee of Bush Terminal Company v. Bailey, N. Y. L. J., Oct. 29, 1940, p. 1309, col. 6 (Sup. Ct. 1940).

6. N. Y. STOCK CORP. LAW § 58, as enacted by N. Y. Laws 1923, c. 787, § 58. On the 1939 amendment, see *infra* p. 312.

7. Plaintiff's view of the proper accounting treatment of the items in issue is supported by substantially all writers: 1 FINNEY, PRINCIPLES OF ACCOUNTING (2d ed. 1934) 314-317; KESTER, ADVANCED ACCOUNTING (3d ed. 1933) 391, 531-532; MONTGOMERY, AUDITING (5th ed. 1934) 279, 281, 312-316, 610; see Comment (1935) 44 YALE L. J. 1025, citing writers on the appreciation question; *cf.* Brandeis, J., dissenting, in United Rys. & Elec. Co. v. West, 280 U. S. 234, 259-288 (1930). The court's treatment of goodwill in the *Bush Terminal* case is indicative of the questions involved in the case but not considered. The goodwill originated in a contract made in 1902 with Irving T. Bush whereby $3,000,000 in common stock of the newly-organized Terminal Company was issued in exchange for an option to buy a plot of undeveloped land and a promise of Bush's future services. The agreement to render future services was not a valid consideration at law for the issuance of stock. DODD, STOCK WATERING (1930) 46-49. According to accounting practice, these services could be capitalized only as part of the cost of construction of property supervised by Bush, and such costs would be written off in depreciation

however, contended that the book values determined by the directors in good faith were conclusive, and that, even if such values were to be disregarded, a valuation of the company's assets as of each dividend date would show surplus available for the payment of dividends. The court held, however, that the value called for by the dividend section was neither the value of the assets as determined by proper accounting methods, nor the value fixed by the directors. "The test being whether or not the value of the assets exceeds the debts and the liability to stockholders, all assets must be taken at their actual value. I see no cause for alarm over the fact that this view requires directors to make a determination of the value of the assets at each dividend declaration. . . . If directors have blindly or complacently accepted either cost or any other arbitrary figures as indicative of value, they have not exercised either discretion or judgment and no court is required to act as if they had."[8] In applying this test, the court decided that there was an element of value in the going concern which the directors could recognize as goodwill, that the recording on the books of the increased land values, although unrealized, was proper because the property was worth at least the amount so recorded, and that the investments in subsidiary companies were improperly carried at book values which did not reflect true values. Defendants prevailed because, as so valued, the assets exceeded liabilities and stated capital by an amount sufficient to show a surplus after each dividend payment.

The technique to be employed to ascertain the "actual value" of the assets of the corporation is hardly clarified by a consideration of the opinion. Although the court considered evidence of value presented by both sides based on reproduction cost and capitalization of earnings, it rested its determination on the values reached in a compromise of tax assessments between New York City and the trustee.[9] The proper method of valuation for dividend and similar purposes, according to most financial writers and the Securities and Exchange Commission, however, is to capitalize expected future earnings.[10] The problem of prediction of future earnings and selection of rate

charges—which was not done here. Nor does the option support the court's treatment of goodwill. If the option had value because the named purchase price was below the then current worth of the land, the subsequent write-up of the Company's properties would include the same item of value. Moreover, it is clear from the facts as developed in the opinion and memoranda of counsel that the stock was not issued in a purchase of a going business. Since accounting recognizes goodwill only when a business is acquired, an accountant would not certify the correctness of the treatment of goodwill. *Cf.* Douglass v. Ireland, 73 N. Y. 100 (1878).

8. Walter, J., in Randall, as Trustee of Bush Terminal Company v. Bailey, N. Y. L. J., Oct. 29, 1940, p. 1309, col. 6 (Sup. Ct. 1940).

9. Cases holding that tax assessments are evidence on the question of value in condemnation or foreclosure proceedings, would seem inapplicable in view of the court's statement in the *Bush Terminal* case that "certiorari proceedings [to review tax assessments] long have been a game in which everyone asks a reduction to the lowest point which one can hire an appraiser to swear to."

10. See 1 BONBRIGHT, VALUATION OF PROPERTY (1937) 216-266; DEWING, FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934) 144 *et seq.*; Comment (1940) 49 YALE L. J. 492, 501 *et seq.*; *cf.* Genessee Valley Gas Co., Inc., 3 S. E. C. 104, 112 (1938).

at which to capitalize make this procedure an exceedingly delicate task. The disinclination of the court to attempt the task reveals an implicit recognition of the problems in store for directors at each dividend declaration. Directors who, like the court, use market measures such as assessed values, run the danger of improper valuation. As the court's principle is practised, it may develop finally that the usual presumption in favor of the directors' figure[11] will be given conclusive effect, so that actual value will mean no more than the directors' value.

Although the wording of the New York statute seems ambiguous enough to support a conclusion favoring either current or accounting valuation, the statutory interpretation which the court chose is significant. The words of the statute, as it existed during the period involved, were:

> "No stock corporation shall declare or pay any dividend which shall impair its capital or capital stock, nor while its capital or capital stock is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon a reduction of the number of its shares or of its capital or capital stock, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, . . . shall be at least equal to the aggregate amount of its debts and liabilities including capital or capital stock. . . ."[12]

On the ground of grammatical impossibility, the court did not rest its decision upon the construction that the phrase "unless the value of its assets" meant current value and related back to the opening clause that "no stock corporation shall declare or pay any dividend"; it preferred, instead, to rely upon an historical survey of the clauses dealing with impairment of capital.[13] The

11. Compare value in stock watering cases, 2 BONBRIGHT, VALUATION OF PROPERTY (1937) 790 *et seq.*; DODD, STOCK WATERING (1930) 57 *et seq.*

12. N. Y. STOCK CORP. LAW § 58, as enacted by N. Y. Laws 1923, c. 787, § 58.

13. See N. Y. Laws 1825, c. 325, § 2; N. Y. Laws 1890, c. 564, § 23; N. Y. Laws 1892, c. 688, § 23; N. Y. Laws 1901, c. 354, § 23; and N. Y. Laws 1923, c. 787, § 58. The 1825 law provided that it was unlawful for directors "to make dividends excepting from the surplus profits arising from the business," and "to divide, withdraw or in any way to pay to the stockholders . . . any part of the capital stock." The 1892 and 1901 laws enacted substantially the same wording. Since the 1923 law dropped the "surplus profits" clause, the court reasoned that the legislature had intended to permit payment of dividends out of any kind of surplus. And a review of the cases arising under the old law showed to the court's satisfaction that even under the "surplus profits" terminology *any* excess of the value of assets over liabilities and stated capital was available for dividends. Such an excess, the court concluded, must include surplus arising from a revaluation of assets. The soundness of the court's argument on the cases may be questioned. Although the judicial statements opposing recognition of appreciated values in fixed assets are generally dicta [Hill v. International Products Co., 129 Misc. 25, 46, 220 N. Y. Supp. 711, 731 (Sup. Ct. 1925), *aff'd*, 226 App. Div. 730, 233 N. Y. Supp. 784 (1st Dep't 1929); Hutchinson v. Curtiss, 45 Misc. 484, 490, 92 N. Y. Supp. 70, 73 (Sup. Ct. 1904); Jennery v. Olmstead, 36 Hun. 536, 539 (N. Y. Sup. Ct. 1885), *aff'd*, 105 N. Y. 654, 13 N. E. 926 (1887); Southern California Home Builders v. Young, 45 Cal. App. 679, 694, 188 Pac. 586, 593 (1920); Kingston v. Home Life Ins. Co., 11 Del. Ch. 258,

grammatical hurdle which it failed to clear — because it felt that the "value" clause related to the reduction of capital or capital stock situation — might have been surmounted by a reading of the "whether" clause to refer only to "any distribution of assets" and not to the immediately preceding "declare or pay any dividend."

In view of the statutory reasoning of the court, the case furnishes a precedent for construction of the many state statutes which employ as one of the tests of legality the "impairment of capital" wording.[14] Probably in the same category are those states which couch their limitation in terms of the excess of assets over liabilities and stated capital.[15] A number of states,

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274, 101 Atl. 898, 904 (1917), *aff'd*, 11 Del. Ch. 428, 104 Atl. 25 (1918); *cf.* People *ex rel.* Astoria Light, Heat & Power Co. v. Cantor, 236 N. Y. 417, 141 N. E. 901 (1923); Roberts v. Roberts-Wicks Co., 184 N. Y. 257, 77 N. E. 13 (1906)], they are supported by a formidable array of authorities in other fields. See *A Symposium on Appreciation* (1930) 5 ACCOUNTING REV. 1 *et seq.* And the court apparently did not consider Wilson v. Barnett, N. Y. L. J., Aug. 2, 1928, p. 1870, col. 1 (Sup. Ct. 1928), which plaintiff's counsel cited as a holding directly in point on the question of appreciation.

14. Despite obscure and diverse language, the following statutes apparently enact a general capital-impairment limitation: ARIZ. CODE ANN. (Struckmeyer, 1928) § 4804; COLO. STAT. ANN. (Michie, 1935) c. 41, § 34; CONN. GEN. STAT. (1930) § 3386; D. C. CODE (1929) tit. 5, § 278; FLA. COMP. GEN. LAWS ANN. (Skillman, 1927) §§ 6549, 6581; IND. STAT. ANN. (Burns, 1933) § 25-211; IOWA CODE (1939) § 8378; KY. STAT. ANN. (Carroll, 1936) § 548; ME. REV. STAT. (1930) c. 56, § 37; MD. ANN. CODE (Flack, 1939) art. 23, § 92; MO. STAT. ANN. (1932) § 4942; MONT. REV. CODES ANN. (Anderson and McFarland, 1935) § 5939; N. J. REV. STAT. (1937) § 14:8-19; N. M. STAT. ANN. (Courtwright, 1929) § 32-135; N. Y. STOCK CORP. LAW § 58; N. C. CODE ANN. (Michie, 1939) § 1179; N. D. Laws 1931, c. 114, § 4543; OKLA. STAT. ANN. (1936) tit. 18, § 106; ORE. CODE ANN. (1930) § 25-219; R. I. GEN. LAWS (1938) c. 116, § 30; S. D. CODE (1939) § 11.0706; UTAH REV. STAT. ANN. (1933) § 18-2-17; W. VA. CODE ANN. (Michie and Sublett, 1937) § 3090; WIS. STAT. (1939) § 182.19. Some of these statutes enact also an insolvency rule or surplus profits rule. See notes 15 and 16 *infra*. A limited capital-impairment rule is enacted in California, Delaware, Georgia, Kansas and Minnesota. See note 16 *infra*. Several states provide a margin of safety by requiring a debt-asset ratio or a debt-capital ratio. ARIZ. CODE ANN. (Struckmeyer, 1928) § 587 (debts not to exceed 2/3 of capital stock); NEB. COMP. STAT. (1929) § 24-205 (same); N. D. LAWS 1931, c. 114, § 4543 (debts not to exceed capital stock); OKLA. STAT. ANN. (1936) tit. 18, § 129 (same); UTAH REV. STAT. ANN. (1933) § 18-2-44 (assets to be at least 50% in excess of debts). A number of states provide that dividends may not be paid against unrealized appreciation surplus: *e.g.*, Illinois, Michigan, Ohio, Pennsylvania, and Washington.

15. ARK. DIG. STAT. (Pope, 1937) § 2183; IDAHO CODE (1932) § 29-129; ILL. ANN. STAT. (Smith-Hurd, 1934) § 157.41; LA. GEN. STAT. ANN. (Dart, 1939) § 1106; NEV. COMP. LAWS (Hillyer, Supp. 1938) § 1625; OHIO GEN. CODE ANN. (Page, 1937) § 8623-38; PA. STAT. (Purdon, 1937) tit. 15, § 2852-701; TENN. CODE ANN. (Williams, 1934) §§ 3737, 3886; VT. PUB. LAWS (1933) § 5850; VA. CODE ANN. (Michie, 1936) § 3840; WASH. REV. STAT. ANN. (Remington, Supp. 1940) § 3803-24. Six states impose only an insolvency restriction: MASS. ANN. LAWS (1933) c. 158, § 44; MISS. CODE ANN. (1930) § 4149; NEB. COMP. STAT. (1929) § 24-218; N. H. PUB. LAWS (1926) c. 225, § 79; TEX. ANN. REV. CIV. STAT. (Vernon, 1925) art. 1347; WYO. REV. STAT. ANN. (Courtwright, Supp. 1940) § 28-121. The New Hampshire statute specifies insolvency in the sense of insufficiency of assets; the other statutes do not indicate whether the condition

however, limit dividends to payment only out of "net earnings," "surplus profits arising from the business," and the like.[16] Since determination of profits is peculiarly within the domain of the accountant, it might be argued that in these states dividend legality is to be tested by sound accounting methods based on historical costs.[17] Some of the capital impairment states, moreover, exculpate directors who have relied in good faith upon the values in financial statements presented by responsible officers and accountants.[18]

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of illegality is inability to meet obligations as they mature, or excess of liabilities over assets. Statutes clearly imposing an insolvency limitation as well as a capital-impairment limitation are found in Colorado, Connecticut, District of Columbia, Illinois, Iowa, Kentucky, Maine, Maryland, and Oregon. See notes 14 and 16 *infra*. The insolvency limitation seems meaningless under such circumstances unless interpreted to mean inability to meet debts as they mature. For an historical explanation, see Kehl, *supra* note 1, at 60. The wording of statutes such as those of Illinois and Iowa, however, appears to require an insufficiency construction.

16. Ala. Code Ann. (Michie, 1928) § 8368 ("surplus profits"); Mich. Stat. Ann. (Henderson, 1935) § 21.22 ("earned surplus or net earnings"—but dividends on preferred stock are payable out of any surplus); Mo. Stat. Ann. (1932) § 5107 ("net profits or surplus earnings" on no par stock only); S. C. Code (1932) § 1353 (dividends must be "actually earned or out of surplus heretofore earned"). Five states permit payment of dividends out of net profits of the current or preceding fiscal year, despite an impairment of the capital represented by common stock: Cal. Civ. Code (Deering, 1937) § 346; Del. Rev. Code (1935) § 2066; Ga. Code Ann. (Park, Supp. 1939) § 22-1835; Kans. Gen. Stat. Ann. (Corrick, Supp. 1939) §§ 17-3501, 17-3502; Minn. Stat. (Mason, Supp. 1940) § 7492-21. The California, Georgia, and Minnesota statutes allow only preferred dividends when common stock capital is impaired. Of the statutes listed in notes 14 and 15, *supra*, as imposing a general capital-impairment or surplus limitation, the following also enact a net profits rule or an accumulated (surplus) profits rule: Arizona, Arkansas, Connecticut, Florida, Indiana, Maryland, Montana, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Utah, West Virginia, and Wisconsin. The statutes of Connecticut, Maryland, and Oregon may be interpreted as enacting the capital impairment, insolvency, and surplus profits rules. See note 14 *supra*.

17. See 2 Bonbright, Valuation of Property (1937) 916-919. Under a surplus profits rule alone it may be held that a dividend is payable when there are current profits or accumulated past profits despite a deficit in capital due to the issuance of stock below par or overvaluation of property received for stock. See discussion of the cases in Comment (1940) 49 Yale L. J. 492, 501, n. 31. Under other circumstances the courts have not adopted the accounting method in measuring income. When stock has been issued at a premium, the resulting paid-in surplus has been regarded as a profit [*cf.* Smith v. Cotting, 231 Mass. 42, 120 N. E. 177 (1918). *Contra:* Merchants' Ins. Co. v. Schroeder, 39 Cal. App. 226, 178 Pac. 540 (1918)], contrary to the view of accountants and financial writers. And it has been held that a gain in the sale of part of the business is a profit available for dividends [Lubbock v. British Bank of South America, [1892] 2 Ch. 198; see note 4 *supra*], although statutes restricting dividends to "surplus profits arising from the business" would clearly require a contrary conclusion.

18. "A director shall be fully protected in relying in good faith upon books of account of the corporation or statements prepared by any of its officials as to the value and amount of the assets, liabilities and/or net profits of the corporation, or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid." Del. Rev. Code (1935) § 2066. See also,

The presence of such statutes might easily warrant a legal conclusion that accounting valuations are to be employed for dividend purposes.[19] The 1939 amendment in New York, however, excusing directors who "affirmatively show that they had reasonable grounds to believe, and did believe, that such dividend or distribution would not impair the capital . . .,"[20] does not necessarily warrant such a conclusion. Although apparently designed to avoid the holding of *Quintal v. Greenstein*[21] that directors, in the absence of statute, could not rely in good faith upon the books of account where assets had been *fraudulently* overvalued by others, the generality of the wording of the amendment fits as well into the attitude of the court in the *Bush Terminal* case. Since the latter case interprets impairment of capital in the statute to require current valuation, a director who must affirmatively show a reasonable belief that capital was unimpaired would be hard put to justify complete reliance upon accounting statements, even though properly prepared.[22]

The haphazard coupling in most state statutes of "capital impairment" language with "profits" and/or "reliance" wording, however, compels the conclusion that in fact no clear legislative intent can be derived from the face of any of the statutes. Courts confronted with the need to choose between the current value standard and the accounting value measure should feel free to base their decisions on the underlying policy consideration — which method will be more likely to furnish adequate protection to creditors and stockholders. The goal of any protective standard should be to retain within the enterprise a margin of asset values over liabilities sufficient to minimize the danger of loss to creditors and shareholders through bankruptcy or reorganization, and to maintain intact the capital goods and working funds with which the corporation does business. Existing state law, however, does not aim to preserve a sufficient margin, but only to maintain the amount of the original stockholders' contribution, however thin by comparison with the contribution of creditors.[23] Accounting valuations, moreover, although a simpler process than current valuation, cannot achieve even the limited purpose of preserving the insufficient contribution of the stockholders. In the case of current assets, such as accounts receivable and merchandise, the method of the accountant has, perhaps, worked substantially to reach the same result

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e.g., CAL. CIV. CODE (Deering, 1937) § 363; ILL. ANN. STAT. (Smith-Hurd, 1934) § 157.42. Dissenting directors are also excused. On the nature of the director's responsibility, see Comment (1926) 35 YALE L. J. 870.

19. On the ground that "books of account" and "statements" are words with a technical meaning, that is, books kept according to standard accounting practice, and statements similarly prepared.

20. N. Y. STOCK CORP. LAW § 58, as amended by N. Y. Laws 1939, c. 364, § 1.

21. 142 Misc. 854, 256 N. Y. Supp. 462 (Sup. Ct. 1932), *aff'd*, 236 App. Div. 719, 257 N. Y. Supp. 1034 (1st Dep't 1932), (1932) 32 COL. L. REV. 905.

22. *Cf.* General Rubber Co. v. Benedict, 215 N. Y. 18, 23, 109 N. E. 96, 97 (1915).

23. Some states such as New York provide merely that the reduction of capital must not go below a stated nominal sum, varying from $300 to $1,000. Another type of statute requires that capital equal liabilities or 50% of liabilities. See note 14 *supra*, and Comment (1935) 44 YALE L. J. 1025, 1040-1042.

as current value standards;[24] but in the case of fixed assets, which for large corporations represent the greater part of total assets, accounting procedure does not maintain current values. In the first place, the original cost shown on the balance sheet as the starting point in the accountant's process of valuing assets may itself be a fanciful figure. The original cost of assets purchased in an open market by a buyer bargaining with a seller at arm's length may, at the time of acquisition, closely approximate real worth. But in the absence of an arm's-length transaction, as in the instance of a deal between two affiliated corporations, the cost assigned to the property may be inflated. And when property is exchanged for stock of the buyer, the difficult question of valuing the property or of valuing the stock in order to allot a cost to the property is usually decided in favor of an arbitrary, generous figure.[25] Some courts, by assigning to the action of the directors in fixing the cost of the property a presumption in favor of their valuation, have completed the process of making cost a caricature of real value.[26] Secondly, the accountant's method of adjusting the original costs of fixed assets such as plant and machinery does not pretend to achieve any measure of current value; instead it is designed to spread the cost of depreciable assets over their useful life.[27] The accountant refuses to recognize even substantial rises or falls in the value of fixed assets, with the major exception of the situation where assets have become virtually worthless due to such factors as a change in the art or mechanics of production or a shift in markets and transportation facilities, and there seems no reason to wait for realization to take the loss.[28] As a result of this shying away from the present actualities of value, the accountant's balance sheet cannot reveal whether the stockholders' contribution is currently maintained.

The inadequacy of accounting valuation for regulation of dividends under the capital impairment rule does not, of itself, mean that adoption of the alternative — current valuation — is a better measure of the retention of the stockholders' original contribution. Modern statutes, although they pay lip service to the sanctity of this contribution, permit the amount of the contribution which must be retained in the business to be reduced to the barest minimum. By the simple device of calling part "capital" and part "paid-in surplus" the directors may free a large part of the contribution for dividends.[29]

24. In a general way, current assets are stated at cost, current replacement values, or realizable values, whichever is lowest. SANDERS, HATFIELD AND MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES (1938) 70, 71.

25. See BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) 252-254; DODD, STOCK WATERING (1930) 57 *et seq.*

26. *Cf.* DODD, STOCK WATERING (1930) 57-97.

27. See Brandeis, J., dissenting, in United Rys. & Elec. Co. v. West, 280 U. S. 234, 260-262 (1930); *cf.* Depreciation Charges of Telephone and Steam Railroad Companies, 177 I. C. C. 351, 392 (1931).

28. See Hosmer, *The Effect of Direct Charges to Surplus on the Measurement of Income*, in MCNAIR AND LEWIS, BUSINESS AND MODERN SOCIETY (1938) 112, 134 *et seq.*

29. At least 22 states permit the creation of paid-in surplus, and among these states are all the important corporation states, except Massachusetts, where such provision in the presence only of an insolvency limitation would be nugatory. Comment (1940) 49 YALE L. J. 492, 496, n. 16, 18. Six states prohibit stating or reducing preferred stock

By means of a charter amendment reducing the company's stated capital and creating surplus to the extent of the reduction, a further part becomes available for dividends;[30] directors may use the "reduction surplus" without running afoul of state statutes, so long as the distribution of dividends does not make the company insolvent.[31] The valuation process employed in the *Bush Terminal* case will tend to increase the ease with which the stockholders' contribution may validly be freed for dividends; therefore, it will decrease whatever protection has hitherto been afforded by the rule against impairment. Required downward revaluations, of course, tend to restrict the distribution policy of a corporation. This tendency, however, can be avoided by recourse to the reduction statute to create surplus for the absorption of the loss on the write-down. On the other hand, the addition of "unrealized appreciation surplus" to the already available dodges of "paid-in surplus" and "reduction surplus" cannot be justified. Apart from the danger that presumptions attaching to the directors' valuation may sanction unwarranted write-ups, the existing level of protection should not be further lowered. Increasing freedom to distribute assets in the form of dividends facilitates dissipation of cash more properly invested in plant and equipment to maintain a company's competitive position,[32] and increases the danger that an illiquid position or an over-preponderance of debt in the capital structure will result in bankruptcy or reorganization, with waste and loss to stockholders and creditors.

Although the shortcomings of accounting values even in measuring continued retention of an adequate stockholders' contribution indicate the general desirability of the court's adoption of the current valuation approach, current valuation is a forward step only in a jurisdiction where the statute is geared to preserve the original investment intact in the business and where there is available a suitable body willing to solve the difficult valuation problems. Such a statute is the dividend section of the Public Utility Holding Company Act of 1935,[33] which directs the Securities and Exchange Commission to

below the agreed consideration or the liquidation preferences. More important in protecting preferred stockholders against dissipation of part of their contribution as dividends is the provision in five states that dividends from paid-in surplus may be paid only to preferred stockholders, who shall be notified of the source. *Id.* at 499, n. 24, 25.

30. See Comment (1935) 44 YALE L. J. 1025; SEC REPORT ON THE STUDY, ETC., OF PROTECTIVE AND REORGANIZATION COMMITTEES, Pt. VII (1938) 483-493.

31. Statutes, as in Connecticut, Delaware and Ohio, prohibit a reduction of capital which leaves assets insufficient to pay corporate debts, and seem to apply to liquidating dividends paid from reduction surplus. Comment (1935) 44 YALE L. J. 1025, 1040. When accompanied by a write-down of depreciable fixed assets against reduction surplus, reducing stated capital is a subtle means of increasing earnings in the future, because the depreciation charges made against income are decreased in consequence of the write-down of the depreciation base. On restriction of write-downs under § 12(c) of the Public Utility Holding Company Act, see Comment (1940) 49 YALE L. J. 492, 504-514.

32. *Cf.* Schmitt v. Eagle Roller Mill Co., 199 Minn. 382, 272 N. W. 277 (1937), (1936) 21 MINN. L. REV. 849 (court will order dividends paid only when withdrawal of assets will not injure the corporation by depleting working funds).

33. Section 12(c), 49 STAT. 823 (1935), 15 U. S. C. A. § 79*l*(c) (Supp. 1940); Comment (1940) 49 YALE L. J. 492, 504 *et seq.*

supervise the valuation process and frowns upon distributions of capital surplus, part of the stockholders' contribution.[34] The desirability of such administrative control of distributions of non-public utility companies may be debatable. But until the New York and other statutes are amended to prevent the dissipation by way of unwise distribution of the stockholders' contribution, employment of current valuation as a means of taking into account unrealized appreciation further accelerates the relaxation of an already weakened protective standard.[35]

ERIE R. R. v. TOMPKINS AND SUPERVENING CHANGES IN STATE LAW*

Erie Railroad v. Tompkins,[1] while destroying the refined concept of a general common law operating in the United States, has left a host of minor doctrines which, upon reexamination, may be found to rest on the validity of the theory of a general jurisprudence. Formerly, the federal judiciary often answered independently of any state court's theory of jurisprudence such questions as whether a federal court must acknowledge a state court's reinterpretation of its own doctrine,[2] whether it should enforce rights relied upon even though a state court repudiates the doctrine,[3] and whether a federal appellate court could look beyond the record for decisive changes in state law and facts.[4] But since the *Tompkins* case, it is not so easy to dismiss these questions as independent of state law; if there is no longer a general common law in diversity of citizenship cases, the right to determine these related matters independently may no longer exist. The problem is presented directly when a federal appellate court is faced with the question of whether a decision on state law made by a district court should be reversed because the highest state court has overruled its prior doctrine subsequent to the district court's ruling.

The Sixth Circuit Court of Appeals has decided that it need not recognize the supervening change in state law.[5] An employee of the Owens-Illinois

34. The Commission's opinions indicate a realistic approach to the need for investor protection in terms of liquidity, sufficiency of common stock equity, and functional valuation of assets. *Cf.* Associated Gas & Elec. Corp., Holding Company Act Release No. 1873, Jan. 10, 1940, (1940) 49 YALE L. J. 1319; Consumers Power Co., Holding Company Act Release No. 1854, Dec. 28, 1939, (1940) 49 YALE L. J. 746.

35. Whatever attitude the court takes on unrealized appreciation, it should restrict dividends to allow for shrinkage. Actual value rather than book value, moreover, may be more desirable as a measure of the amount contributed, at the time of contribution. United Light & Power Co. v. Grand Rapids Tr. Co., 85 F. (2d) 331 (C. C. A. 6th, 1936). See also cases collected in Comment (1940) 49 YALE L. J. 492, 501, n. 31.

* Vandenbark v. Owens-Illinois Glass Co., 110 F. (2d) 310 (C. C. A. 6th, 1940), *cert. granted*, (1940) 9 U. S. L. WEEK 3113.

1. 304 U. S. 64 (1938).
2. This is the problem in the principal case.
3. See note 29 *infra*.
4. See note 14 *infra*.
5. Vandenbark v. Owens-Illinois Glass Co., 110 F. (2d) 310 (C. C. A. 6th, 1940).

Glass Company brought an action in common law negligence for damages resulting from an occupational disease, silicosis, allegedly contracted while working in the company's glass factory. At the time the suit was commenced in the Ohio federal district court this disease was not compensable under the Ohio Workman's Compensation Act.[6] Furthermore, during the previous twenty-five years the Ohio Supreme Court had repeatedly held that an employer's compliance with the Act barred any common law action in negligence.[7] Since it was conceded that the company had complied with the Act,[8] the district court sustained its motion to dismiss on the ground that the petition failed to state a cause of action cognizable under Ohio law. Pending the appeal of the case to the circuit court of appeals, the Ohio Supreme Court reversed its previous interpretation of the Compensation Act so as to allow a common law cause of action in this situation.[9] Refusing to recognize this supervening change in Ohio law,[10] however, the majority of the circuit court affirmed the judgment of the lower court despite the fact that it was pointed out that, had the action been pending in an Ohio court, the cause of action would have been accepted under the Ohio Supreme Court's subsequent ruling.[11]

Interwoven somewhat confusingly in the majority opinion are the several basic rationalizations the federal courts have used to disregard supervening changes in state law. There is, for one, the usual reluctance of a federal appellate court to reverse a district court judgment which was correct when entered, because such action might reflect unfavorably upon the federal court's oft-asserted independence: this might be called the "independent federal judiciary" rationale.[12] Secondly, there is in the majority opinion a bias against giving retroactive effect to the latest utterance of the state court so that it would relate back to the time the suit was begun: this might be termed

6. OHIO CONST. ART. II, § 35; OHIO GENERAL CODE (Page, 1937) § 1465-68a (as amended).

7. Mabley & Carew Co. v. Lee, 129 Ohio St. 69, 193 N. E. 745 (1934); Zajachuck v. Willard Storage Battery Co., 106 Ohio St. 538, 140 N. E. 405 (1922).

8. Vandenbark v. Owens-Illinois Glass Co., 110 F. (2d) 310, 312 (C. C. A. 6th, 1940).

9. Triff v. National Bronze & Alum. Foundry Co., 135 Ohio St. 191, 20 N. E. (2d) 232 (1939).

10. The court also refused to give retroactive effect to the supervening amendment to the Ohio Workmen's Compensation Act (which made silicosis compensable) so far as the employee's cause of action was concerned on the ground that, in the absence of clear expression to the contrary, a statute is presumed to operate prospectively. Vandenbark v. Owens-Illinois, 110 F. (2d) 310, 313 (C. C. A. 6th, 1940).

11. Plaintiff's Reply Brief to Defendant's Supplemental Brief filed after Argument, p. 3, Vandenbark v. Owens-Illinois Glass Co., 110 F. (2d) 310 (C. C. A. 6th, 1940).

12. See Vandenbark v. Owens-Illinois Glass Co., 110 F. (2d) 310, 312 (C. C. A. 6th, 1940), where the court states: "It has long been settled law that the Federal Courts have an independent jurisdiction in the administration of State laws coordinate with, and not subordinate to, that of the State courts, . . ." citing the leading "supervening changes" case, Burgess v. Seligman, 107 U. S. 20, 33 (1882). See cases collected in note 18 *infra*.

the "retroactivity" rationale.[13] And finally, there is the feeling that the sole function of a reviewing tribunal is to search for errors in the record of the lower court as of the time the decree was entered: this might be labeled the "writ of error" rationale.[14] All of these rationales developed in the era of *Swift v. Tyson*,[15] and consequently, a revaluation in the light of the *Tompkins* case is in order.

Reconsideration of the independent federal judiciary rationale seems especially imperative by reason of its particularly close relationship to the doctrine of *Swift v. Tyson*. By the time the leading "supervening changes" case, *Burgess v. Seligman*,[16] came before the Supreme Court in 1882, it was the accepted practice of a federal court in a diversity suit to disregard the applicable state law when the question involved matters of commercial law or general jurisprudence. In extending this practice to supervening changes in state law, the Court made but another inroad upon the already waning authority of state jurisprudence.[17]

The relationship between the philosophy of *Swift v. Tyson* and the philosophy of federal independence of change in state law may be seen by comparing the types of situation in which supervening changes arose. The first

13. "A decision of the highest court of the State construing a State Statute rendered after a judgment of a Federal District Court, cannot be given a retroactive effect so as to make that erroneous which was not so when the judgment of that court was given." 110 F. (2d) 310, at 312. See Concordia Ins. Co. v. School Dist. No. 98, 282 U. S. 545 (1931); and also Morgan v. Curtenius, 20 How. 1 (U. S. 1857), where this rationale was first pronounced.

14. "The precise question that meets us here is whether a Federal District Court has correctly applied state law at the time decision was made, ..." 110 F. (2d) 310, at 313. See Kansas P. Ry. v. Twombly, 100 U. S. 78 (1879); Aetna Life Ins. Co. v. Hoppin, 214 Fed. 928 (C. C. A. 7th, 1914). *Contra:* Minnesota v. National Tea Co., 309 U. S. 551 (1940); Patterson v. Alabama, 294 U. S. 600 (1935); Missouri *ex rel.* Wabash Ry. v. Public Serv. Comm., 273 U. S. 126 (1927); Dorchy v. Kansas, 264 U. S. 286 (1924); Watts, Watts & Co., Ltd., v. Unione Austriaca di Navigazione &c., 248 U. S. 9 (1918); Gulf, C. & S. F. Ry. v. Dennis, 224 U. S. 503 (1912). Judge Allen, dissenting in the principal case, relied on the opposite rationale which runs through these cases that a federal court, in the exercise of its appellate jurisdiction, "has power not only to correct errors in the judgment entered below, but to make such disposition of the case as justice may require; and in determining what justice now requires, the court must consider the changes in fact and in law which have supervened since the decree below was entered." This doctrine has by all odds been the dominant rationale in "supervening change" cases of the last quarter century, having impliedly repudiated the "writ of error" line of cases.

15. 16 Pet. 1 (U. S. 1842).

16. 107 U. S. 20 (1882).

17. *Swift v. Tyson* had interpreted the phrase "laws of the several states" in the Rules of Decision Act, 1 STAT. 92 (1789), 28 U. S. C. §725 (1934) to include, in addition to state statutes, their construction by the courts of the state and also strictly local matters such as real estate law. Since most of the decisions in line with *Burgess v. Seligman* have been concerned with supervening changes in the latter two matters, it can readily be seen that the federal courts have encroached upon that very province of state law which, according to the Rules of Decision act as interpreted in *Swift v. Tyson*, they were required to follow religiously.

was where a federal court, having had the first chance to interpret an hitherto uninterpreted state law, was confronted shortly thereafter with a contrary construction by the state court. Here the usual practice was for the "independent" federal judge to interpret the state law as he saw it and stand by his declaration despite a subsequent pronouncement to the contrary by the state court.[18] The second situation was where a federal court, having followed the supposedly settled construction of the state law in making its decision, was faced soon thereafter with a redefinition of this law by the highest state court. In this case a federal judge would generally, though not invariably, follow the state court's reinterpretation of the law, perhaps because, not having originally declared the law, his subsequent withdrawal seemed to smack less of judicial subservience to the every whim of the state forum.[19] In contrast to both these situations, which involved supervening changes in state judicial law, it has been the settled practice for a federal judge to accept without hesitation supervening changes in state statutory law, a field invariably omitted from inclusion in the body of general law. Thus, in this third type of situation, a supervening alteration in a state statute, whether it resulted in the deletion of an undesirable feature of a challenged act[20] or an amendment which made valid an allegedly invalid administrative order,[21] was accepted as determinative of the issue in the federal forum. In view of the degrees of independence asserted by federal courts in these situations, it seems fairly clear that federal judges faced with supervening changes were largely motivated in reaching their decisions by the philosophy of a general common law not dependent on state decisions for its authenticity.

In this light, the independent federal judiciary rationale seems destroyed almost necessarily by the *Tompkins* case. There can be no doubt now but that a federal judge must follow state substantive law; the only question is what evidence of this substantive law shall he consider as controlling.[22]

18. Concordia Ins. Co. v. School Dist. No. 98, 282 U. S. 545 (1931); Burgess v. Seligman, 107 U. S. 20 (1882); Roberts v. Bolles, 101 U. S. 119 (1879); Pease v. Peck, 18 How. 595 (U. S. 1855); Forsyth v. Hammond, 71 Fed. 443 (C. C. A. 7th, 1896), *rev'd on mistaken impression that subsequent decision was rendered prior to the institution of the action,* 166 U. S. 506 (1897). *Contra:* Glenn v. Field Packing Co., 290 U. S. 177 (1933); Fidelity Nat. Bank & Trust Co. v. Swope, 274 U. S. 123 (1927); Fleischman Const. Co. v. Burns, 284 F. 358 (C. C. A. 6th, 1922); Western Union Tel. Co. v. Poe, 64 Fed. 9 (C. C. S. D. Ohio 1894). In the *Glenn v. Field Packing Co.* case, the Supreme Court expressed an extremely liberal attitude toward this type of supervening change when it subjected a federal injunction of an allegedly invalid Kentucky tax to the condition that, should the state court ever hold that the tax does not violate the state constitution, the district court must dissolve its decree. See (1934) 47 HARV. L. REV. 708.

19. Sioux County v. National Surety Co., 276 U. S. 238 (1928); Bauserman v. Blunt, 147 U. S. 647 (1893); Groner v. United States, 73 F. (2d) 126 (C. C. A. 8th, 1934); *Contra:* Morgan v. Curtenius, 20 How. 1 (U. S. 1857); Aetna Life Ins. Co. v. Hoppin, 214 Fed. 928 (C. C. A. 7th, 1914).

20. Texas Co. v. Brown, 258 U. S. 466 (1922).

21. Board of Pub. Util. Comm'rs v. Compania General de Tabacos de Filipinas, 249 U. S. 425 (1919).

22. See Shulman, *The Demise of Swift v. Tyson* (1938) 47 YALE L. J. 1336, 1349-50.

In the pre-*Tompkins* era a federal judge, when speaking in the "independent federal judiciary" idiom, might refer to a supervening change in the law as but a single decision overruling a long line of established precedent[23] or as a decision clearly against the weight of authority[24] which it would be unbecoming to the dignity of a national tribunal to recognize, especially where another federal court had previously proclaimed its will on the subject. Apart from the problem of supervening changes, such an attitude of independence, grounded as it was in a belief that the state court was wrong on the merits of the case, is clearly rejected by the *Tompkins* rule which would seem to make the latest decision of the state court, if clear, authoritative in the federal forum.[25] If this holds true for state decisions rendered prior to the time of judgment in a federal court, there can be little reason for retaining the independent federal judiciary rationale as applied to supervening changes simply because, in point of time, the particular state decision follows rather than precedes the moment of judgment. Surely, if the state decision is the warp of state law by which the federal courts must abide, the temporal order of pronouncement is the woof.

Since the *Tompkins* rule seems to repudiate the independent federal judiciary rationale in so far as the doctrine permits a contemporary state decision to be ignored, federal courts which wish to maintain a policy of "non-recognition" toward supervening changes in state non-statutory law may be forced to fall back on the second rationale in the majority opinion — a refusal to give retroactive effect to the state decision "so as to make that erroneous which was not so when the judgment of [the lower court] was given."[26] This retroactivity rationale has validity as an independent ground of decision in a supervening change case only if it is valid as a general principle applicable to all judicial decisions. And the validity of this general principle under the *Tompkins* rule turns on the question of what evidence of state substantive law a federal court is privileged to take as controlling its decision.

As for such evidence, the Sixth Circuit Court of Appeals in the principal case seems to have had a choice between two possible theories of retroactivity. For one, it could have considered that the declaration by the Ohio Supreme Court that an employee had always had a common law cause of action for an occupationable disease was a specific substantive ruling that, regardless of what the law had previously been, the latest decision was to be applied retroactively.[27] On the other hand, it could have interpreted the Ohio court's

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23. Pease v. Peck, 18 How. 595, 599 (1855), where the court refused to recognize a supervening decision because it did not have "the character of established precedent declarative of the settled law of a State." But see Mr. Justice Holmes, dissenting in Kuhn v. Fairmont Coal Co., 215 U. S. 349, 372 (1910), and Mr. Justice Cardozo, speaking for the Court in Hawks v. Hamill, 288 U. S. 52, 58 (1933).

24. Forsyth v. Hammond, 71 Fed. 443 (C. C. A. 7th, 1896).

25. Erie R. R. v. Tompkins, 304 U. S. 64, 78-79 (U. S. 1938). See (1940) 40 Col. L. Rev. 1251, 1254-5.

26. Vandenbark v. Owens-Illinois Glass Co., 110 F. (2d) 310, 312 (C. C. A. 6th, 1940). See note 13 *supra*.

27. Triff v. National Bronze & Alum. Foundry Co., 135 Ohio St. 191, 206, 20 N. E. (2d) 232, 238 (1939).

declaration as an application of the Blackstonian presumption operative in Ohio that a court, in overthrowing a rule of law, neither makes new law nor changes the old but simply declares the law as it has always existed.[28] Since either of these theories of retroactivity would obviously be part of the substantive law of Ohio, the circuit court would seem bound to follow the supervening Ohio ruling as the best evidence of the Ohio law at the time of its determination of this appeal.

To this general presumption that a judicial decision operates retrospectively one important exception is usually made — *i.e.*, when contract rights have accrued in reliance on the overruled decision.[29] It might be argued that the circuit court would be justified in the principal case in using this so-called *Gelpcke*[30] exception were it not for the fact that the exception itself — much like the independent federal judiciary rationale — emanated from the self-asserted right of the federal courts to disregard overruling decisions of state courts, adherence to which, it was felt, would work gross injustice. Since the *Tompkins* rule has unmistakably disavowed this particular attitude of independence, it is doubtful whether the federal courts are still privileged not to apply an overruling state decision retroactively on this ground;[31] instead it is now presumably their duty to follow the particular theory of retroactivity prevailing in the state out of which the case arose. Thus, in the principal case it would seem incumbent on the circuit court to recognize the Ohio rule on retroactivity: namely, that every new decision is presumed to operate retroactively unless an actual contract made in reliance on the old decision can be proved.[32] As this rule is the clearest evidence of the sub-

28. Lewis v. Symmes, 61 Ohio St. 471, 56 N. E. 194 (1900). For a general discussion of the so-called Blackstonian theory, see Snyder, *Retrospective Operation of Overruling Decisions* (1940) 35 ILL. L. REV. 121.

29. Great Southern Fire Proof Hotel Co. v. Jones, 193 U. S. 532 (1904); Gelpcke v. Dubuque, 1 Wall. 175 (U. S. 1863); Rowan v. Runnels, 5 How. 134 (U. S. 1847). Cases are collected in Note (1935) 97 A. L. R. 515. See Snyder, *Retrospective Operation of Overruling Decisions* (1940) 35 ILL. L. REV. 121, 130.

30. Gelpcke v. Dubuque, 1 Wall. 175 (U. S. 1863). It is now well established that neither the constitutional prohibition against impairing obligation of contract nor the due process clause of the Fourteenth Amendment can be invoked to prevent a state court from abrogating accrued rights. See Tidal Oil Co. v. Flanagan, 263 U. S. 444, 450-51 (1924).

31. Even before the *Tompkins* case, the *Gelpcke* rule was seriously delimited in Marine National Exchange Bank v. Kalt-Zimmers Mfg. Co., 293 U. S. 357 (1934), and Hawks v. Hammill, 288 U. S. 52 (1933). See Frankfurter & Hart, *The Business of the Supreme Court at October Term, 1932* (1933) 47 HARV. L. REV. 245, 290, n. 111; Comment (1935) 41 W. VA. L. Q. 131, 135; (1935) 14 TEX. L. REV. 391, 395-96. That the present Supreme Court disapproves of the *Gelpcke* rule may be inferred from Mr. Justice Frankfurter's reference to "the discouraging history of such a juristic sport as was the doctrine of *Gelpcke v. Dubuque*." Oklahoma Packing Co. v. Oklahoma Gas & Elec. Co., 309 U. S. Appendix, p. .... (1939), *withdrawn on rehearing by order of the Court*, 308 U. S. 530 (1940).

32. City of Sidney v. Cummins, 93 Ohio St. 328, 113 N. E. 218 (1916). See Woodbridge, *A History of Separation of Powers in Ohio: A Study in Administrative Law* (1939) 13 U. CIN. L. REV. 191, 270.

stantive law pertaining to the reliance exception in Ohio, it would appear that no exception to the Ohio doctrine of retroactivity can be made in the principal case, involving as it does only a tort claim.[33]

If, then, both the independent federal judiciary and retroactivity rationales seem to be invalid under the *Tompkins* case, the federal courts must take refuge in the third idea running through the majority opinion — the writ of error rationale. A deep-seated loyalty to procedural conventions served to motivate this rationale. It has long been the classic function of an appellate judge sitting on the "law" side of the court, as distinguished from "equity," to examine the record of the court below for mistakes in facts or law only as of the time the decree was entered.[34] Hence, shifts in facts or law, taking place after the writ of error was obtained, by definition lay outside the record.

This writ of error convention, however, was but half-heartedly observed. Supervening changes in fact, for instance, were invariably accepted by the reviewing courts. Where the parties settled the case out of court,[35] where the party lost his standing to sue,[36] where some supervening event made it impossible to grant effectual relief[37] — in each instance federal courts changed the lower court judgment to conform to the altered fact situation. Another circumstance where this procedural convention was disregarded was in an appeal from the highest state court to the Supreme Court. Here the writ of error rationale might logically have been invoked on the theory that the Supreme Court in the proper exercise of its appellate jurisdiction should consider only those errors in the record which have to do with the federal question, the presumption being that the state adjudication on non-federal matters is final when the case leaves the hands of the state judges.[38] Therefore, it is surprising to discover the Supreme Court, when confronted with supervening changes in state law which occur during such an appeal, circumventing the strictures of the writ of error concept by vacating the judgment and remanding to the lower court for further proceedings.[39] In view of this failure of federal courts to adhere strictly to the writ of error concept, it seems somewhat illogical, on a conceptual level at least, to rely on this doctrine in cases of supervening change in state law.[40]

33. It is possible for the company to argue that it did not take out private insurance to cover liability arising from tort suits based on "silicosis" claims by reason of its reliance on the twenty-five-year-old Ohio rule denying a common law cause of action for this occupational disease. It is doubtful, however, whether the company could bring this "negative" reliance within the Ohio contract exception.

34. See cases cited *supra* note 14. See ARNOLD & JAMES, CASES AND MATERIALS ON TRIALS, JUDGMENTS AND APPEALS, 718.

35. Dakota County v. Glidden, 113 U. S. 222 (1885).

36. Heitmuller v. Stokes, 256 U. S. 359 (1921).

37. Brownlow v. Schwartz, 261 U. S. 216 (1923) (writ of mandamus).

38. See (1940) 49 YALE L. J. 1463.

39. Missouri *ex rel.* Wabash Ry. v. Public Serv. Comm., 273 U. S. 126 (1927); Gulf, C. & S. F. Ry. v. Dennis, 224 U. S. 503 (1912). For a discussion of the vacation and remand device as a means of circumventing the writ of error rationale, see (1940) 49 YALE L. J. 1463, 1466; 1 FREEMAN, JUDGMENTS (5th ed. 1925) § 199.

40. It might also be argued conceptually that a court which indulged the Blackstonian presumption would have to recognize supervening changes even under the writ of error

Illogical though it may be in practice, the writ of error rationale may nonetheless continue to serve as a loophole for a federal judge who does not wish to recognize a supervening change in state law — unless by some means it can be brought within the mandate of the *Tompkins* rule. At the outset it would appear that, as this rationale is concerned with the way a federal court handles the substantive law presented to it — seemingly a matter of internal policy — it should be classified as a matter of procedure and thereby clearly beyond the reach of the *Tompkins* rule. It must be observed, however, that such a categorization would pervert the real meaning of the procedural-substantive dichotomy under the *Tompkins* rule. Since the clear purpose of this rule is to equalize the law applicable in state and federal forums in diversity cases,[41] any force which tends to set up a disequilibrium between the two courts might well be classified as "substantive" rather than "procedural."[42] In the principal case, for example, reliance on the writ of error rationale would keep the employee from obtaining a right to which she would have been entitled in the state forum. Consequently, a federal court wishing to adhere to the spirit of the *Tompkins* doctrine should refuse to rely on the writ of error doctrine, even though conceptually it is not a part of state law.

In the final analysis, a reintegration of these three rationales into the emerging pattern of the *Tompkins* doctrine is essential to its successful operation. Unless the subordinate question of the methods of determining the applicable state law in diversity suits is answered in accordance with the underlying philosophy of the *Tompkins* case, the new doctrine may be frustrated early in its career. The decision in the principal case, if applied, might well be a first step toward so undermining *Erie Railroad v. Tompkins.*

EXEMPTION FROM INCOME TAX OF INCREMENT UNDER INSURANCE INSTALLMENT AND ANNUITY OPTIONS*

TAX exemptions granted by Congress because of constitutional doubts whether certain receipts are income or capital have raised vexing questions in relation to the income tax.[1] The problem is one of determining how far

concept because the subsequent state decision, as a statement of the "true" rule, demonstrated that the original judgment was erroneous when entered.

41. Erie R. R. v. Tompkins, 304 U. S. 64, 74 (1938).

42. See Sampson v. Channell, 110 F. (2d) 754, 756 (C. C. A. 1st, 1940), where Judge Magruder, speaking for the court, said that the moving consideration of policy behind the *Tompkins* rule is that "it is unfair and unseemly to have the outcome of litigation substantially affected by the fortuitous existence of diversity of citizenship. Hence, the greater likelihood there is that litigation would come out one way in the federal court and another way in the state court if the federal court failed to apply a particular local rule, the stronger the urge would be to classify the rule as not a mere matter of procedure but one of substantive law falling within the mandate of the Tompkins case." See also Cook, *"Substance" and "Procedure" in the Conflict of Laws* (1933) 42 YALE L. J. 333.

* Comm'r v. Winslow, 113 F. (2d) 418 (C. C. A. 1st, 1940).

1. PAUL, STUDIES IN FEDERAL TAXATION (3d Series, 1940) 352.

Congress wants its exemptions to extend — whether to all receipts capable of inclusion in the exemption or only to those required by the constitutional limitation on income.[2] A particularly troublesome question arises as to payments consisting partly of taxable income and partly of capital which is expressly exempt from tax.

Payments under installment and annuity options of life insurance policies are examples of such mixed receipts which squarely raise the issue of the scope of the Congressional exclusions from gross income.[3] Since these payments are made over a period of years, the beneficiary receives more than if he had been fully paid immediately upon the death of the insured.[4] Income taxation of this increment depends on whether the Congressional exemption is construed broadly enough to include the part of the payment that is income as well as the part that is capital.

There are three standard life insurance options by which an insured may provide for the payment of increment as well as principal to his beneficiary. The first option — proceeds at interest — provides that the company retain the principal amount of the policy, pay interest thereon to a primary beneficiary for life, and then pay the principal to a secondary beneficiary. No question of mixed receipts arises in relation to payments under this option because the capital amount of the policy is paid to one person at one time and the interest is paid to a different person at another time. In *United States v. Heilbroner,*[5] these interest payments were recognized as income and taxed as such.

Under the second standard option — installments certain — the company pays the beneficiary a specified annual amount for a designated number of years. According to the third option — annuity settlement — the beneficiary receives a definite annual sum for life. Payments under the second and third options consist of mixed receipts. Part of what the beneficiary receives is capital because it is derived from the amount which, in the absence of a choice of optional payment, would have been payable immediately upon the death of the insured. The remainder of the payment is interest paid by the company in return for the use of that part of the capital value of the policy retained by the company during the years intervening between the insured's death and the date of payment.[6]

2. In Pollock v. Farmers' Loan & Trust Co., 157 U. S. 429 (1895), *rehearing,* 158 U. S. 601 (1895) the income tax of 1894 [28 STAT. 553 (1894)] was declared unconstitutional by a divided Court on the ground that it was a direct tax and consequently had to be apportioned among the states according to population. U. S. CONST. Art. I, § 9. Since the Sixteenth Amendment removed the apportionment requirement only as to taxes on income, capital is still immune from unapportioned taxes. See Eisner v. Macomber, 252 U. S. 189, 206 (1920).

3. See note 25 *infra.*

4. The amount by which the payments to the beneficiary under the options exceed the sum payable at the death of the insured varies directly with the length of time for which payments are made. See note 6 *infra.*

5. 100 F. (2d) 379 (C. C. A. 2d, 1938); *cf.* Edith M. Kinnear, 20 B. T. A. 718 (1930).

6. The difference between the value of the policy at the date the insured dies and the actual amount of the payments to the beneficiary is roughly equal to the return on

The statute requires that the beneficiary be taxed on such payments if they are made in accordance with an option which he, and not the insured, has exercised.[7] If the choice of the option was made by the insured, however, there is a statutory exemption which must be considered in determining whether the beneficiary is liable for a tax on any part of his receipts.[8] This exemption is Section 22(b)(1) of the Internal Revenue Code which makes the following exclusion from gross income:

> "Life insurance — amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise (but if such amounts are held by the insurer under an agreement to pay interest thereon, the interest payments shall be included in gross income.)"[9]

The word "otherwise" appeared in the Code for the first time in 1934 when it was substituted for "in installments." The reports of the House and Senate Committees concerned with this change state:

> "This change makes it clear that the proceeds of a life insurance policy payable by reason of the death of the insured in the form of an annuity are not includible in gross income."[10]

One point which the committee reports clarified is that the capital amount of life insurance policies is exempt from tax regardless of when it is paid. Prior to 1926, it was questionable whether this amount was exempt when paid in the future because the statute said that "amounts paid upon the death of the insured" were to be excluded from gross income.[11] By changing the wording in 1926 to read "by reason of the death of the insured," Congress attempted to eliminate any significance which might be attached to the time of payment of the capital value of the policy.[12] The change in 1934 made it clear that the 1926 amendment covered not only the interest and installment options which were specifically mentioned, but the annuity option as well.[13] There is a question, however, whether the committee reports and statutory changes also indicate a broader intended exemption. If the phrase

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the capital amount at the prevailing interest rates. In the bond which the beneficiary receives upon surrendering the policy when the insured dies, the rate of interest on which the installments are based is stated. It has been held that the segment of installment payments which represents increment is not deductible by the insurance company as interest on indebtedness. Penn Mutual Life Ins. Co. v. Comm'r, 92 F. (2d) 962 (C. C. A. 3d, 1937). See note 34 *infra*.

7. INT. REV. CODE § 22(b)(1) (1939). If the insured dies without having chosen an optional payment, the beneficiary may select such payment. Payments are taxable to the beneficiary, however, when paid according to his direction since they are not then paid by reason of the death of the insured.

8. INT. REV. CODE § 22(b)(1) (1939).

9. *Ibid.*

10. H. R. REP. No. 704, 73d Cong., 2d Sess. (1934) 21; SEN. REP. No. 558, 73d Cong., 2d Sess. (1934) 23.

11. 43 STAT. 267 (1924).

12. 44 STAT. 24 (1926); *Conf. Rept., H. R. 1*, 69th Cong., 1st Sess. (1926) 33.

13. See note 10 *supra*.

"amounts received under a life insurance contract"[14] is interpreted broadly, it will include any increment in mixed receipts and thus exempt the entire payment from tax.

Such broad interpretation was recently made by the First Circuit Court of Appeals in *Commissioner v. Winslow*.[15] The case involved the taxable status of a payment of $2,000 made to the taxpayer as beneficiary of his father's life insurance policy. Before his death, the father chose to have payment made in accordance with the installments certain option which provided that the son was to receive fifty annual installments of $2,000 each. The Board of Tax Appeals held that the entire installment was exempt from tax by Section 22(b)(1).[16] The decision was affirmed on appeal in an opinion which is somewhat confusing because of its admissions and assumptions.[17] The court readily accepted the Government's minor premise that only $53,000 of the $100,000 which the taxpayer would eventually receive represented life insurance.[18] The major premise of the Government's case — that only life insurance was exempt from tax by Section 22(b)(1)— was rejected.

In support of this rejection, the court relied on the 1934 amendment and the committee reports explaining the reason for it. By this reliance the court interpreted the statutory changes broadly enough to extend to increment as well as capital in the life insurance optional payments, and repudiated the contention that those changes related to the capital segment alone. Although the position of the court is defensible as a possible interpretation of the statute, the more limited interpretation of the statutory changes may be found to be preferable.

One factor to be considered in determining which interpretation should be adopted is the purpose of Section 22(b)(1) and its relationship to the rest of the provisions dealing with gross income. It might be argued, of course, that because of the Congressional disposition to treat life insurance favorably, the exemption of proceeds is intended to cover interest as well as capital. Legislative belief in the social desirability of life insurance as well as in the efficacy of tax exemption as a device for encouraging investment in it is evidenced by the limited exemption of life insurance proceeds under the federal estate tax.[19] Federal courts have consistently refused, however, to recognize tax exemptions based upon implications from the statute and have insisted that the legislature manifest a clear intention that certain receipts

14. This phraseology has been used in the Internal Revenue Code since 1926, but it means the same as "proceeds of a life insurance policy" which appeared in the early statutes and also in the committee reports of 1934 and the two are used interchangeably.

15. 113 F. (2d) 418 (C. C. A. 1st, 1940).

16. Sidney W. Winslow, Jr., 39 B. T. A. 373 (1939).

17. Comm'r v. Winslow, 113 F. (2d) 418, 422 (C. C. A. 1st, 1940), (1940) 54 HARV. L. REV. 142.

18. Stated conversely, the $53,000 represents the present, or commuted, value of $100,000 payable in installments of $2,000 for fifty years.

19. INT. REV. CODE § 811(g) (1939). For a discussion of the treatment of life insurance proceeds under state income tax laws, see Neuhoff, *Gross Income and Deductions Under State Income Tax Laws* (1937) 22 IOWA L. REV. 185, 186.

are to receive favored treatment.[20] Consequently, it would seem necessary for a taxpayer claiming exemption of interest payments under Section 22 (b)(1) to establish legislative intent by something more tangible than the fact that Congress might have had a valid reason for granting an exemption.

Even if one were permitted to imply tax exemptions, such implication would seem to be unjustified in the instant case. Although the reasons for the steadfast Congressional policy of excluding life insurance proceeds from gross income are not clearly defined, one significant factor has been the doubt of the constitutionality of taxation of these receipts.[21] Although an argument can be made in support of such a tax,[22] a large group of Congressmen have argued that such payments are not within the limited concept of income to which their taxing powers are confined.[23] This explanation of the exemption of life insurance proceeds in terms of constitutional doubt is entirely consistent with the general scheme of organization of the Internal Revenue Code. Following the sweeping attempt in Section 22(a) to tax all "income derived from any source whatever,"[24] Congress made exclusions from gross income in Section 22(b). A preponderant number of excluded items, including gifts, bequests, devises, life insurance proceeds and part of annuities, are exempted in broad general language reflecting doubts as to their status as taxable income.[25] A few, like "the rental value of a dwelling house . . . furnished to a minister of the gospel as part of his compensation," which are dictated by reasons of policy, are precisely defined by specific language.[26] The context of the life insurance exemption in Section 22(b) thus lends support to the argument that the exemption is in large part based on constitutional doubts. If, then, the exemption is a constitutional one, it would seem appropriate to restrict it to its constitutional limits because, as a general rule, an exemption is held to be coextensive with the reason for it.[27] The interest segment would thus fall outside the exemption because it is clearly taxable income.

20. United States Trust Co. v. Helvering, 307 U. S. 57, 60 (1939); Trotter v. Tennessee, 290 U. S. 354, 356 (1933); Bank of Commerce v. Tennessee, 161 U. S. 134, 146 (1896).

21. Since Congress has exempted proceeds of life insurance contracts paid by reason of the death of the insured in every revenue act since 1913, the question of income taxability of such receipts has never arisen directly. In the case of the United States v. Supplee-Biddle Hardware Co., 265 U. S. 189, 195 (1924) there is dictum to the effect that such payments "are not usually classed as income." Although the authorities are hesitant in taking a position on the question, they conclude that the general understanding of most people would be that life insurance proceeds paid on the death of the insured would not be income. See MAGILL, TAXABLE INCOME (1936) 335, 338; PAUL, *op. cit. supra* note 1, at 355.

22. Maguire, *Capitalization of Periodical Payments by Gift* (1920) 34 HARV. L. REV. 20.

23. 50 CONG. REC. 3844 (1913). See Harriss, *Legislative History of Federal Gift Taxation* (1940) 18 TAXES 531.

24. INT. REV. CODE § 22(a) (1939). *Cf.* Irwin v. Gavit, 268 U. S. 161 (1925).

25. See MAGILL, TAXABLE INCOME (1936) 319.

26. INT. REV. CODE § 22(b)(6) (1939). Such items are customarily listed in Section 23 as deductions from gross income. MAGILL, TAXABLE INCOME (1936) 319.

27. Matter of Haedrich, 134 Misc. 741, 236 N. Y. Supp. 395 (Surr. Ct. 1929).

The argument that Congress intended to exclude interest payments from the exemption is reenforced by a comparison of Congressional treatment of interest segments in other instances. Section 22(b)(2), which provides an arbitrary measure for the increment on a commercial annuity,[28] is the most elaborate step taken by Congress specifically to restrict its exclusions from gross income to the non-taxable segment of mixed receipts. Another specific attempt to tax increment is made in the parenthetical clause of Section 22 (b)(1) which prevents the exemption of the capital sum of life insurance paid under the proceeds at interest option from being extended to interest payments as well.[29]

These Congressional efforts directed toward taxing increment in specific cases of mixed receipts would seem to be indicative of the broader purpose to limit the exclusions from gross income to capital alone, unless one assumes that specific spelling out implies that omitted types are to be treated differently. But, this assumption does not seem to be justified in view of the realities of the legislative process. Physical limitations render impossible the enactment of specific statutory provisions for the ascertainment, segregation and taxation of all types of mixed receipts. In some situations, however, complexities are so great that a specific statutory scheme of tax is imperative;[30] in others, Section 22(a) may appear sufficiently broad to cover the interest segment of mixed receipts, but Congress may find it convenient to make specific provisions in aid of the general. For example, the proceeds at interest option was the most common type of optional payment at the time the specific provision in Section 22(b)(1) for taxing increment was inserted. This type of provision is more likely to be illustrative of the treatment that should be applied to the entire group of receipts than an attempt to separate one class of receipts from others which are similar and tax it alone.

A resolution of the doubt about Congressional intent in enacting and amending Section 22(b)(1) is of no small importance. The *Winslow* case, by implying an exemption, makes payments under both the installments certain and annuity settlement options[31] entirely tax free. Considerable losses of federal revenue will result from this not only because of the tax free

28. Under this section it is presumed that each annuity payment includes a return of 3% on the cost of the annuity. This amount of each payment is taxable and the remainder is excluded until the exclusions equal the cost, after which time all annuities are considered to be income and taxable.

29. The clause is quoted on p. 324. See also the cases cited in note 5 *supra*.

30. INT. REV. CODE § 22(b)(2). See (1937) 11 TEMP. L. Q. 567 for the view that, even as expressed in statute, the scheme of taxation was unconstitutional. *Cf.* F. A. Gillespie, 38 B. T. A. 673 (1938) (constitutionality of § 22(b)(2) sustained).

31. The *Winslow* case deals with payments under the installments certain option, but the court speaks of the payments as annuities. Although the term is properly used to refer to any periodic payments, its strict meaning is limited to payments for life. See Bodine v. Comm'r, 103 F. (2d) 982, 984 (C. C. A. 3d, 1939). The decision of the court may be assumed to apply to the annuity as well as the installment situation. Computation of the taxable segment of payment under the two options is made in virtually the same manner. U. S. Treas. Reg. 103, § 19.22(b)(1)-1(b) and (c).

nature of these standard options,[32] but because of their natural advantages as a form of insurance settlement.[33] A resolution of the doubt in favor of limiting the exemption would, of course, prevent such losses. It is possible that other circuits may be induced to accept the Government's position and thus make more likely a consideration of the issue by the Supreme Court,[34] or that Congress will amend the section to provide for specific taxation of the increment. But until either is done, the present interpretation of the exemption leaves a regrettable loophole whereby income disguised as capital escapes taxation.[35]

SETTLEMENT OF TORT CLAIMS AGAINST THE GOVERNMENT BY PRIVATE ACTS*

BROAD expansion of federal activities has lent urgency to the importance of securing adequate redress for those injured by torts of the federal government.[1] To date, however, only limited provisions have been made for ad-

32. This applies especially to wealthy taxpayers who invest part of their income this way to avoid high surtax rates.

33. Optional payments are becoming increasingly popular today because of their superiority to single sum payments in providing the insured's family with a steady and safe income of the kind to which they are accustomed. See Horton, *The Testamentary Nature of Settlements of Life Insurance Elected by the Beneficiary* (1931) 17 CORN. L. Q. 72. When tax saving is added to the other advantages of the options, their popularity may be expected to increase even more rapidly. PAUL, *op. cit. supra* note 1, at 418, 419.

34. The issue has been tried in the Second Circuit Court of Appeals and a decision similar to that in the *Winslow* case was reached. Comm'r v. Bartlett, 113 F. (2d) 766 (C. C. A. 2d, 1940). See also Ellsworth B. Buck, 41 B. T. A. No. 15 (1940). It should be noted that reversal of the *Winslow* case taxing the beneficiary on part of installment and annuity payments as interest might require reversal of Penn Mutual Life Ins. Co. v. Comm'r, 92 F. (2d) 962 (C. C. A. 3d, 1937). For the effect of such a reversal, see note 6 *supra*.

35. A comparable tax avoidance device exists by virtue of the decision in Burnet v. Whitehouse, 283 U. S. 148 (1931). The trustee's implied power to invade corpus was there held to convert payments of trust income into gifts which were excluded from the beneficiary's gross income because of the exclusion in Section 22(b)(3). The exemption of the beneficiary forces the tax upon the trustee and by the use of multiple trusts, wealthy taxpayers can split large incomes into small taxable units and avoid surtaxes. For a complete discussion of this method of tax avoidance, see (1940) 49 YALE L. J. 1496; Comment (1939) 34 ILL. L. REV. 348, 351 n. 20. Although payments from corpus would not be taxable income, it had been held that payments from the income of the trust were taxable to the beneficiary [Irwin v. Gavit, 268 U. S. 161 (1925)] and it is difficult to see how the mere power to invade corpus can alter the fact that payments are actually made from trust income. A reversal of the *Winslow* decision with a thoroughgoing analysis of payments into their fundamental segments might prove a valuable auxiliary in the eventual assault on the rule of *Burnet v. Whitehouse*.

* Bang v. United States, 31 F. Supp. 535 (D. Minn. 1940).

1. See Borchard, *The Federal Tort Claims Bill* (1933) 1 U. OF CHI. L. REV. 1; Harriman, *Proposed Tort Jurisdiction of the Court of Claims* (1932) 12 B. U. L. REV.

ministrative compensation of tort damage;[2] and courts, restricted by the doctrine of sovereign immunity and the absence of a statutory waiver,[3] have confined judicial relief to personal actions against offending agents in situations where they may be considered to have acted outside the scope of their authority.[4] The circuitous mode of redress forced upon injured claimants by the absence of an administrative or judicial remedy against the government is illustrated in a recent district court case.[5] The plaintiff, who had suffered personal injuries and property damage from a fire caused by a government-operated railroad, secured the passage of a private act for his relief. The belief of the Comptroller General that the act vested discretion in him to refuse the claim made it necessary, however, to enforce the appropriation in a suit under the Tucker Act.[6] Although the recourse to the courts which was necessary in this case was unusual — private acts are usually so phrased that the Comptroller General cannot dispute the finality of the legislative settlement[7] —, Congressional appropriation to redress tort injury by the government remains the customary and most important method of satisfying individual claims.

Congressional adjustment of tort claims has been greatly hampered by the recognized inadequacies of legislative procedure for the disposition of essen-

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232; Holzoff, *Tort Claims Against the United States* (1939) 25 A. B. A. J. 828; McGuire, *Tort Claims Against the United States* (1931) 19 GEO. L. J. 133.

2. See note 20 *infra*.

3. The theoretical background of the doctrine of sovereign immunity and its anomalous effect are thoroughly discussed in Borchard, *Government Liability in Tort* (1924) 34 YALE L. J. 1, 129, 229; (1926-7) 36 YALE L. J. 1, 757, 1039; (1928) 28 COL. L. REV. 577, 734.

4. The restriction of this remedy to cases where the agent has acted beyond his authority frequently leaves the injured party without any judicial remedy whatsoever. See Ross Const. Co. v. Yeardsley, 103 F. (2d) 589 (C. C. A. 8th, 1939); Block v. Sassaman, 26 F. Supp. 105 (D. Minn. 1939). Where the remedy does exist it is liable to penalize agents who have acted with reasonable belief that they had authority, as in Little v. Barreme, 2 Cranch 169 (U. S. 1804), thereby tending to make government officers hesitant in executing their duty.

5. Bang v. United States, 31 F. Supp. 535 (D. Minn. 1940).

6. 24 STAT. 505 (1887), 28 U. S. C. §§ 41(20), 250(1) (1934). This act permits suits against the United States "founded upon the Constitution of the United States or any law of Congress, . . . upon any regulation of an executive department, upon any contract express or implied, or for damages liquidated or unliquidated in cases not sounding in tort." The jurisdiction in the *Bang* case was permitted as an action under a law of the United States. An interesting possibility of this act is that actions might be brought for tortious violations of the Constitution since the phrase "not sounding in tort" apparently does not limit actions based on the Constitution. See Dooley v. United States, 182 U. S. 222 (1901). Courts, however, now apply this restriction to such actions. See Klebe v. United States, 263 U. S. 188 (1923).

7. Occasionally the private act does not make a direct appropriation but gives the Court of Claims or a district court jurisdiction to try the case as if the United States were suable in tort. See Harbor Springs v. United States, 72 Ct. Cl. 32 (1930). The act on which this suit was based is Act of July 3, 1926, c. 837, 44 STAT. 1708 (1926). The large majority of acts settling tort claims, however, consist of direct appropriations. See, for example, 53 STAT. 1535 (1939).

tially judicial or administrative matters.[8] Particularly unfortunate is the limited investigation of the merits of individual claims which the restricted facilities of an overburdened Congress afford.[9] The Committees for Claims of the House and Senate, to which the bulk of this work is delegated, are physically unable to consider all claims referred to them. Those which do receive attention are investigated in an *ex parte* proceeding by a one-man subcommittee which does not have time to secure direct testimony and bases its reports on affidavits and departmental reports of varying quality.[10] Furthermore, since the committees are constantly subject to pressure from legislators proposing bills to benefit constituents, their determinations are inevitably influenced by considerations unrelated to the merits.[11]

The patent defects of committee investigation have caused development of an additional check on the merits of private bills in the House of Representatives. The House rules provide that if two objections are made to the passage of a private bill when it comes up for consideration on the private calendar, it must be recommitted to the reporting committee;[12] and it is the practice of each party to delegate to three members the politically unpleasant task of examining each bill and objecting to those believed without merit.[13] Acting somewhat as a board of review over the claims committee of the House, this unofficial group by its approval practically assures passage of a bill and by its objections delays and often prevents it.[14] The additional check, however, is of little value; although it may have the effect of eliminating some bills without merit, it discourages committee responsibility, substituting for

8. See Holzoff, *loc. cit. supra* note 1. John Adams, writing in 1832, made this critical observation: "There ought to be no private business before Congress . . . It is judicial business and legislative assemblies ought to have nothing to do with it. One-half the time of Congress is consumed by it and there is no common rule of justice for any two of the cases decided. A deliberative assembly is the worst of all tribunals for the administration of justice." 8 MEMOIRS OF JOHN QUINCY ADAMS, Diary, Feb. 23, 1832, 480.

9. See Luce, *Petty Business in Congress* (1932) 26 AM. POL. SCI. REV. 815.

10. See LUCE, LEGISLATIVE PROBLEMS (1935) 610. Compare the English procedure for handling private bills which is adversary and conducted much like a trial. DODD & WILBERFORCE, PRIVATE BILL PROCEDURE (1898). This type of proceeding, however, is expensive for the participants and rarely available for persons with simple tort claims against the government. See LUCE, *op. cit. supra* at 575.

11. See Nutting, *Legislative Practice Regarding Tort Claims Against The State* (1939) 4 MO. L. REV. 1.

12. See CANNON, PROCEDURE IN THE HOUSE OF REPRESENTATIVES (3d ed. 1939) 269.

13. See Luce, *supra* note 9, at 820.

14. Until recently only one objection was sufficient to block the passage of a private bill, and there was little chance of reconsideration in the same Congress. LUCE, LEGISLATIVE PROBLEMS (1935) 609. Under the present rule, two objections are necessary and the objector's action is less final, for the bills remanded can be reported back in the form of an omnibus bill which embodies several such bills as separate titles. The omnibus bills are given precedence on the private calendar one day a month and are considered under restricted rules of debate. After passage, the omnibus bills are broken down and engrossed separately. CANNON, PROCEDURE IN THE HOUSE OF REPRESENTATIVES (3d ed. 1939) 269.

the committee's judgment one at least as cursory and equally subject to political influence.[15]

More serious than the failure adequately to appraise the merits is the uncertainty of the system of legislative adjustment and its consequent failure to develop a coherent policy of relief for government torts. Throughout the legislative process a constant series of eliminations occur in which factors of political pressure and exigencies of parliamentary procedure are as determinative as actual merit.[16] Some claims are never considered in committee, some are killed by uninformed objections, and still others pass one House but are prevented by limitations of time from passing the other in the same Congress.[17] As a consequence, ultimate adjustment of meritorious claims is highly fortuitous, and the residue of bills which survive the legislative process do not express consistent principles of responsibility for harms caused by government agents.

Widespread realization of the defects in Congressional adjustment of tort claims has resulted in delegation of portions of this function to courts and administrative agencies. The United States can now be sued for maritime torts,[18] and authority has been given the heads of administrative departments to settle claims under $1,000 for property damage resulting from the negligence of an officer or employee acting within the scope of his employment.[19] In addition the heads of certain agencies have been given authority to determine claims for property damage and personal injuries arising from specific activities.[20] At present a bill is under consideration in the Senate

15. Such criticism frequently appears in the debates in Congress. See 80 CONG. REC. 3892 (1936).

16. See *Hearings before Subcommittee of the Committee on the Judiciary on S. 2690*, 76th Cong., 3d Sess. (1940).

17. In the 74th Congress 2508 bills were referred to the Claims Committee of the House and only 1118 of these were reported. 81 of these bills were killed by objections and 232 failed because adjournment of Congress occurred before final action could be taken. COMMITTEE OF CLAIMS, HISTORY OF LEGISLATION SEVENTY-FOURTH CONGRESS (1936).

18. 41 STAT. 525 (1920), 46 U. S. C. § 742 (1934).

19. 42 STAT. 1066 (1933), 31 U. S. C. § 215 (1934). Such settlements are certified to Congress as a legal claim for payment and appropriations usually follow automatically. Since no alternative judicial remedy has been provided, the determination of the head of the department is final, and the injured party has no choice but to accept it. See United States v. Babcock, 250 U. S. 328 (1919).

20. The Secretary of War is empowered to settle claims for damages resulting from heavy gunfire, target practice, and military manoeuvers. [37 STAT. 586 (1912), 5 U. S. C. § 208 (1934)]; damages incident to the training, practice, operation or maintenance of the Army [42 STAT. 725 (1922), 31 U. S. C. § 223 (1934)]; damages from army aircraft [42 STAT. 737 (1922), 31 U. S. C. § 224 (1934)]. The Director of the Coast and Geodetic Survey can settle claims for damages caused by the work of the Survey [41 STAT. 929, 1054 (1920), 33 U. S. C. § 853 (1934)]; the Postmaster General can settle damage claims arising from the operation of the Post Office Department [42 STAT. 63 (1921), 5 U. S. C. § 392 (1934)]; the Secretary of Interior can settle claims for damages incident to Indian irrigation projects [45 STAT. 1252 (1929), 25 U. S. C. § 388 (1934)]; the Secretary of Agriculture can settle damages from forest improvement work [46 STAT.

which attempts to enlarge the authority for judicial and administrative settlement of tort claims.[21] Under this bill the United States could be sued in the Court of Claims or a district court for up to $7,500 for personal injuries or property damage resulting from the fault of an agent acting within the scope of his authority, provided there was no contributory negligence and that wilful misconduct or drunkenness was not a proximate cause of the injury. In addition, the bill would permit administrative departments and independent agencies to settle claims for personal injury as well as property damage up to $1,000, and would remove present non-uniformity of departmental adjustments by requiring the Attorney General to provide rules of settlement and to review all awards exceeding $500.[22]

Although such a statute would enable a large number of tort claims to be adjusted by administrative departments and the courts and would thus be a desirable improvement, it would not end the necessity of legislative settlements.[23] Congressional action would be required both when the permissible amount of recovery would be inadequate and also in the several cases of tort injuries which are expressly excluded from the operation of the statute. Moreover, the basis of liability under the proposed statute is the fault of an agent; this would in many instances prevent justifiable recovery in the courts. There are many situations which between private individuals give rise to liability without fault,[24] and it seems desirable to hold the United States similarly responsible in the same circumstances.[25] In France recovery against the government is frequently permitted for non-negligent harm, the theory being that such injuries are a cost of government which should be paid in damages and distributed equally by recovery through taxes.[26]

387 (1930), 16 U. S. C. § 574 (1934)]; and the Attorney General can settle damage claims resulting from the activities of the Federal Bureau of Investigation [49 STAT. 1184 (1936), 5 U. S. C. § 300(B) (Supp. 1939)].

21. S. 2690. An identical bill, H. R. 7236, was introduced in the House of Representatives and passed Sept. 12, 1940. An additional provision for administrative settlement of tort damage is made in the Walter-Logan Bill, S. 915, passed by the Senate Nov. 26, 1940. § 4(d) provides for the determination by an administrative board of damages suffered by an aggrieved person from unauthorized action taken by an agency without a prior hearing when such procedure is required by an emergency. The amount of the damages, if acceptable to the injured person, would then be certified to Congress for an appropriation.

22. At the present time there is no agency to coordinate the settlement activity of the various departments and as a consequence there has been considerable non-uniformity in settlement policy. See McGuire, *supra* note 1, at 139.

23. The large number of contract claims which appear in the claims committees despite the provisions made for such claims under the Tucker Act [24 STAT. 505 (1887), 28 U. S. C. §§ 41(20), 250(1) (1934)] substantiates this prediction. See LUCE, LEGISLATIVE PROBLEMS (1935) 604.

24. See Bohlen, *The Rule in Rylands v. Fletcher* (1911) 59 U. OF PA. L. REV. 298.

25. This would merely require the extension of the rationale which supports the Federal Employees Compensation Act, 39 STAT. 742 (1916) 5 U. S. C. §§ 751-795 (1934).

26. The French administrative courts have developed this theory in their case law in connection with administrative operations in the field of public works. More recently it has been extended to damages resulting from administrative activities in the fields

Since it is unlikely that legislative settlement of tort claims will ever be completely avoided, attempts should be made to render this process more efficient and to facilitate the formulation of general principles against which the merits of an individual claim may be measured. A possible development is an increased emphasis on the veto power of the President. At present this power, which is exercised most frequently against private bills and is particularly effective in these instances because it is rarely overridden,[27] has been used to develop negatively a certain coherence of policy for handling such bills as survive the legislative process. It is apparent from the veto messages that the President has referred to general tort concepts in determining whether a bill should receive his approval. Bills have been vetoed because investigation disclosed that the government agent was not negligent[28] or that the injury occurred while the agent was outside the scope of his employment.[29] The veto is most frequently used where it appears that the amount awarded exceeds the general policy of awards for the particular type of injury,[30] and messages have gone so far as to suggest that similar bills employing a different measure of damages would be approved.[31] But the exercise of this power is limited because, operating on bills after they have gone through the legislative process, it only incidentally influences the consideration of bills while still in Congress.

It would be possible, however, to extend the coordinating effect of executive supervision of legislative tort claim settlements. At the present time, administration of the presidential veto is largely in the hands of the Bureau of the Budget. The Bureau conducts an independent investigation based on reports received from the various departments to determine whether or not a particular bill conforms to the general policy of such relief measures and is otherwise meritorious.[32] Under the existing system, this determination is made after the bill has passed both Houses and within the limited time allowed for the President's veto.[33] If private relief bills were brought within the system which now exists to coordinate departmental activity concerning pending legislation other than private relief bills—a system also administered by the Bureau of the Budget[34]—, the Bureau's determination would be avail-

of public health and police. Trotabas, *Liability in Damages Under French Administrative Law* (1933) 13 J. COMP. LEG. & INT. L. 56.

27. From 1789 through 1937 the president vetoed 750 bills; 49 vetoes were overridden. Of the bills vetoed 483 were private bills and only 6 of these vetoes were overriden. See Berdahl, *The President's Veto of Private Bills* (1937) 52 POL. SCI. Q. 505.

28. See veto message on H. R. 4482, reported in 84 CONG. REC. 11227 (1939).

29. See veto message on H. R. 5603, reported in 83 CONG. REC. 5295 (1938).

30. See veto message on H. R. 3657, reported in 83 CONG. REC. 5462 (1938).

31. See veto message on S. 2271, reported in 84 CONG. REC. 11174 (1939).

32. See BUDGET CIRCULAR No. 346 (1937).

33. The bill first comes to the attention of the Bureau of the Budget after it has passed both houses and has been printed at the government printing office. Thus the Bureau is limited in its investigation to the 10-day period permitted by the Constitution for the President's veto. U. S. CONST. Art. I, § 7, cl. 2. An additional one or two days are secured by the practice of securing facsimiles of the original bill before it is enrolled.

34. This system was initiated upon the recommendation in PRESIDENT'S COMMITTEE ON ADMINISTRATIVE MANAGEMENT, REPORT WITH SPECIAL STUDIES (1937) 359. The

able while the bill was still in committee and would influence legislative as well as executive action. Under the clearance system, departmental reports to the Congressional Committees discussing proposed legislation are first submitted to the Bureau to determine whether or not the report or recommendation conforms to the program of the President;[35] the inclusion of private relief bills would require the Bureau to investigate the bill at the time when the report of the department in which the tort was committed was presented to the claims committees of the House. An adverse recommendation at this time would probably halt further consideration of a bill unless the defect were one that could be cured by amendment, and would indicate that, if the bill were nonetheless passed, the Bureau would advise a presidential veto. On the other hand, a favorable report would probably bring the committee's approval, and the existence of this impartial appraisal of the merits would render delay by action of an objector less likely. Thus, by a change that would merely require an executive order,[36] the entire legislative process for adjusting tort claims would be expedited, and there would be some likelihood that the bills passed would express a coherent policy of relief.

In view of the growing governmental responsibility for the economic and social welfare of its citizens, it is anomalous that redress of federal government torts should be largely restricted to individual relief in private acts.[37] This incongruity stems principally from the Anglo-American rule of sovereign immunity from suit, which in the United States has prevented direct judicial relief against the government without express statutory authorization[38] and in England has prevented extension of the historic remedy of a petition of right to include actions in tort.[39] In France, where during the republic no

Bureau was originally concerned with legislation involving fiscal matters, but now its work includes activity concerning all pending legislation other than private relief bills. See BUDGET CIRCULAR No. 344 (1937); Weeks, *Initiation of Legislation by Administrative Agencies* (1940) 9 BROOKLYN L. REV. 117.

35. See BUDGET CIRCULAR 344 (1937).

36. This authority is provided by 53 STAT. 561 (1939), 5 U. S. C. § 133 (Supp. 1934).

37. See Holzoff, *loc. cit. supra* note 1.

38. Kiefer & Kiefer v. Reconstruction Finance Corp., 306 U. S. 381 (1939), indicates a tendency away from strict construction of statutory waivers of sovereign immunity in respect to government corporations. Considerable confusion has existed as to whether the "sue and be sued" clause generally contained in the statute creating these corporations subjects them to suit in tort. See Naylor, *Liability of the United States Government in Tort* (1940) 14 TULANE LAW REV. 417. The *Kiefer* case permitted such a suit where there was no "sue and be sued" clause, inferring the intent to permit suits in tort from the recent legislative tendency to waive sovereign immunity.

39. English law has not applied the doctrine of sovereign immunity to the extent it has been used in the United States. The petition of right, an institutionalized derivative of the ancient practice of petitioning the king for favors and justice, antedated the immunity doctrine and supplied a common law remedy in real actions and later contract actions against the Crown. The procedure was changed by the Petition of Rights Act, 23 & 24 VICT. c. 34 (1860), but the substantive requirements of liability were not changed. As yet a simple tort cannot be redressed by this method. See Holdsworth, *History of Remedies Against the Crown* (1922) 38 LAW Q. REV. 141.

such inhibition has operated, the administrative courts have developed a considered scheme of protection against government torts.[40] By a broad extension of the statutory authority for judicial and administrative settlements the advantages of the French system could be introduced in the United States. Since no major legislative progress seems imminent in Congress, however, it is essential that every effort be made to improve the existing scheme of legislative settlement. To this end supervision and investigation of pending bills by the Bureau of the Budget appears highly desirable.

FEDERAL GIFT TAXATION OF DONATIVE TRANSFERS TO FAMILY CORPORATIONS*

FEDERAL gift tax legislation[1] broadly purports to tax all inter vivos transfers of property[2] made without full consideration.[3] Yet specific construction of certain gift tax provisions has been a subject of conjecture where donative transfers are made to corporations.[4] In computing taxable net gifts,[5] the Revenue Act of 1932 provided for the exclusion of the first $5,000 in "gifts

40. In the past seventy years the French administrative courts have welded extensive pecuniary remedies for government torts into the general body of administrative jurisprudence by which the citizen is protected from unconstitutional and unauthorized actions of administrative authorities. The unusual characteristic of this body of jurisprudence is that it has been developed by tribunals designed to protect the administration from judicial interference by the civil courts and is based on principles distinct from those by which the rights of individuals against each other are determined. See Riesenfeld, *French System of Administrative Justice: A Model For America* (1938) 18 B. U. L. REV. 48, 400; Trotabas, *Liability in Damages Under French Administrative Law* (1930) 12 J. COMP. LEG. & INT. L. 44; Garner, *French Administrative Law* (1924) 33 YALE L. J. 597.

*Frank B. Thompson, 42 B. T. A. No. 24, June 18, 1940.

1. REVENUE ACT OF 1932, § 501, 47 STAT. 245 (1932), 26 U. S. C. § 550 (1934). The gift tax is a primary and personal liability of the donor. U. S. Treas. Reg. 79, Art. 3. Previous gift tax legislation was enacted in the REVENUE ACT OF 1924, 43 STAT. 313, but was repealed in 1926. 44 STAT. 126 (1926). The constitutional validity of the 1924 gift tax was upheld as to its prospective operation in Bromley v. McCaughn, 280 U. S. 124 (1929).

2. 47 STAT. 245 (1932), 26 U. S. C. § 550(b) (1934). See U. S. Treas. Reg. 79, Art. 2; SEN. REP. No. 665, 72d Cong., 1st Sess. (1932) 39; H. R. REP. No. 708, 72d Cong., 1st Sess. (1932) 27, 28.

3. 47 STAT. 247 (1932), 26 U. S. C. § 552 (1934). See U. S. Treas. Reg. 79, Art. 8.

4. See BREWSTER, THE FEDERAL GIFT TAX (1933) § 16; MONTGOMERY, FEDERAL TAXES ON ESTATES TRUSTS AND GIFTS (1938–39 ed.) 396.

5. 47 STAT. 247 (1932), 26 U. S. C. § 553(a) (1934). "The term 'net gifts' means the total amount of gifts made during the calendar year, less . . . deductions . . ." The deductions are set out in 26 U. S. C. § 554 (1934). See U. S. Treas. Reg. 79, Arts. 12, 13.

. . . made to any person by the donor during the calendar year."[6] Hence, when gifts are made to corporations, computation of the tax requires decision as to whether the corporation itself or each individual shareholder is the proper donee.[7] The corporate fiction raises a further problem where the donor is himself a shareholder. Whether the donor is taxable upon the aggregate value transferred to the corporation or only upon that portion accruing to the beneficial interest of the other shareholders hinges upon whether the corporate entity is to be recognized or disregarded.

The existence of a corporation as an entity distinct from its shareholders for gift tax purposes was directly in issue in a case recently decided by the Board of Tax Appeals.[8] In 1932 petitioner created a Kentucky corporation to which he transferred valuable securities. In return the corporation issued to him its authorized capital stock of 100 shares. Petitioner retained 50 shares in his own name, transferred 20 shares to his wife, and created three trusts of 10 shares each, with himself as trustee, for three of his children. His wife subsequently transferred 10 of her shares in trust for a fourth child, naming petitioner as trustee. The corporation was used solely as a holding company and issued no more stock. In each of the years from 1933 through 1935, petitioner made additional transfers of cash and securities to the corporation. In computing his gift tax liability, petitioner excluded from the category of "gift" one half of the value of the additional transfers because of the interest he retained in the corporation. The remaining portion of the transfers he treated as individual gifts to the other shareholders, claiming in each year five separate exclusions of $5,000. The Commissioner of Internal Revenue assessed a deficiency, contending that the amounts transferred to the corporation were taxable in the aggregate as gifts, and, since the corporation was the proper donee, that only one $5,000 exclusion should be allowed in each year. The Board of Tax Appeals upheld the Commissioner's ruling, and indicated further in a dictum that the value of the shares remaining in petitioner's possession at death would be subject to an estate tax without credit allowance for the amount of gift tax paid.[9] Petitioner's contention was rejected as an attempt to "leap over the legal existence and ownership of the corporation."[10]

Corporations are described as "persons" in the Revenue Act,[11] and the exclusion provision of the gift tax statute is explicit in exempting from tax the first $5,000 in "gifts . . . made to any person."[12] Basing its decision

6. 47 STAT. 247 (1932), 26 U. S. C. § 553(b) (1934). This section was amended by the REVENUE ACT OF 1938, § 505, 52 STAT. 565 (1938), 26 U. S. C. § 553(b) (Supp. 1938), decreasing the exclusion from $5,000 to $4,000 on gifts made after the year 1938.

7. BREWSTER, THE FEDERAL GIFT TAX (1933) 26.

8. Frank B. Thompson, 42 B. T. A. No. 24, June 18, 1940, *appealed* Sept. 9, 1940, Prentice-Hall 1940 Fed. Tax Citation Serv., p. 4157 (C. C. A. 6th).

9. 47 STAT. 278 (1932), 26 U. S. C. § 413(a)(2) (1934). See U. S. Treas. Reg. 80, Art. 9(a).

10. Frank B. Thompson, 42 B. T. A. No. 24, June 18, 1940, p. 2.

11. REVENUE ACT OF 1932, § 1111(a)(1), 47 STAT. 289. The same provision is contained in the REVENUE ACT OF 1934, § 801(a)(1), 48 STAT. 771.

12. 47 STAT. 247, 26 U. S. C. § 553(b) (1934). See note 6 *supra*.

upon this language, the Board concluded that the corporate "person" was the proper donee of the transfer. The decision thus follows the doctrine, often expressed by the courts in income tax cases, that corporate form must be strictly observed in matters of taxation.[13]

Yet the result in the present case seems to conflict with the accepted judicial definition of a transfer by gift. In determining the nature of a gift for tax purposes, the courts have accepted and applied the concept of a transfer developed in estate taxation,[14] asserting that a transfer relates to the relinquishment of control over the economic benefits of property rather than to a change in technicalities of legal title.[15] Where gifts are made in trust with a power reserved in the settlor to revoke,[16] or to modify the trust,[17] no gift tax is assessed at the time the trust is created. The power to revoke or modify the trust is considered a sufficient retention of control over the economic benefits of the property to defeat the gift. Thus not every transfer without consideration is a transfer by gift within the meaning of the act. When a shareholder makes a donative transfer to a family corporation, legal title to the property transferred vests in the corporation. But the shareholders have an equitable or beneficial interest in the corporate property.[18] The donative transfer is reflected by an increase in the value of their proportionate interests. To the extent that the donor shareholder's interest in the family corporation has been increased in value by the transfer, it would seem that no economic benefits have passed. His property has changed in form, legal title has shifted, but he retains control over an equivalent amount in economic

13. See note 38 *infra.*

14. Merry, *Federal Estate and Gift Tax: Concept of a Transfer* (1940) 38 MICH. L. REV. 1032, 1039. In Burnet v. Guggenheim, 288 U. S. 280, 287 (1933), the view was expressed that Congress knew the essence of a transfer as developed in estate taxation and might be deemed to have adopted it for gift tax purposes. *Cf.* Estate of Sanford v. Comm'r, 308 U. S. 39, 43 (1939). Cases defining the nature of a transfer for estate tax purposes have arisen largely in determining whether or not a prior gift in trust is sufficiently complete to prevent a taxable interest passing at death. In deciding that there was no complete inter vivos transfer, the courts uphold assessment of the estate tax.

15. See Burnet v. Guggenheim, 288 U. S. 280, 287 (1933); Estate of Sanford v. Comm'r, 308 U. S. 39, 43 (1939); Welch v. Davidson, 102 F. (2d) 100, 102, 103 (C. C. A. 1st, 1939).

16. See Burnet v. Guggenheim, 288 U. S. 280 (1933) (power of revocation expressly reserved in the settlor); Comm'r v. Allen, 108 F. (2d) 961 (C. C. A. 3d, 1939), (1940) 53 HARV. L. REV. 690 (power of revocation imposed by law). The *Guggenheim* case arose under the 1924 gift tax. In reenacting gift tax legislation in 1932, Congress expressly provided that a power of revocation reserved in the settlor rendered a gift in trust incomplete for tax purposes. Upon relinquishment of such power the transfer was deemed taxable. REVENUE ACT OF 1932, § 501(c), 47 STAT. 245, 246. In 1934, after the decision in the *Guggenheim* case, this provision was repealed as being declaratory of existing law. 48 STAT. 758 (1934). See SEN. REP. No. 558, 73d Cong., 2d Sess. (1934) 50.

17. Rasquin v. Humphreys, 308 U. S. 54 (1939); Hesslein v. Hoey, 91 F. (2d) 954 (C. C. A. 2d, 1937), *cert. denied,* 302 U. S. 756 (1937); see Estate of Sanford v. Comm'r, 308 U. S. 39, 43, 44 (1939).

18. 1 FLETCHER, CYCLOPEDIA OF CORPORATIONS (perm. ed.) § 31, n. 45; 11 *id.* § 5100.

value.[19] Failure to penetrate the web of technical legal title and to search the underlying interests of the shareholders thus seems to result in the creation of a fictitious gift for tax purposes.[20]

Creation of a family holding corporation provides a device whereby the father retains control over all the property transferred while purporting to divest himself of it. The degree of effective control retained may well be greater than in the case where a trust is created with powers reserved in the settlor to revoke or to modify terms of the trust. A realistic approach[21] to the tax problem involved would require a gift tax only on the portion of the donative transfers accruing to the benefit of the other shareholders. If the other shareholders subsequently sold their stock, revenue would not be lost. At the father's death, an estate tax could be levied on the value of the entire corporate property with credit allowance for gift taxes paid.

It is apparent in the principal case that the value of the donor shareholder's interest in the corporation at death would properly be included as part of his gross estate at death and subject to an estate tax.[22] To the extent that this interest reflects the donative transfer, both estate and gift taxes would be imposed and collected on the same value. The Board's dictum expressly approving this result fails to give effect to a primary purpose of gift taxation. The gift tax provision was passed as a corollary to the estate tax in order to prevent complete loss of revenue where estate taxes are avoided by inter vivos gifts.[23] A provision in the estate tax statute allows a credit

19. The problem is illustrated by extending the rule of the principal case to the situation where the donor is sole shareholder of a corporation created to hold his investments. A transfer of securities to the corporation by its shareholder would constitute a gift subject to tax if the result in the instant case were followed. However, a recent decision has rejected this unrealistic approach in the sole shareholder situation. Robert H. Scanlon, 42 B. T. A. No. 146, Oct. 18, 1940, 9 U. S. L. WEEK 2258. Although refusing to disregard the corporate entity and treating the transaction as a transfer from one person to another, the Board held that the increase in value of the sole shareholder's interest in the corporation "compensated" for the transfer, thus removing it from the gift category. This decision seems to leave the Board in the anomalous position of assessing no gift tax at all where the donor owns all of the corporate shares, and assessing a gift tax on the entire amount transferred where the donor owns 95% of the shares in a family corporation. An attempted justification of this distinction is made on the ground that administrative difficulties are encountered where more than one shareholder is involved. Robert H. Scanlon, *supra*. But it would seem that no insuperable difficulties should arise in ascertaining the proportionate interests of shareholders in a family holding corporation and assessing the gift tax on that basis.

20. The effect of the decision in the instant case might be avoided by issuing at the time of the donative transfer new shares to *all* shareholders of the family corporation in proportion to their holdings. The donor shareholder would not be taxed on the value of the transfer accruing to his benefit since he would receive shares in return. He would be taxed on the value of the stock issued to each of the other shareholders and presumably would be entitled to a separate exclusion for each.

21. In relation to the income tax, the Supreme Court has treated the concepts of ownership and control in a realistic economic sense rather than in narrow legal terms. Helvering v. Clifford, 309 U. S. 331 (1940), 49 YALE L. J. 1305.

22. 44 STAT. 70 (1926), 26 U. S. C. § 411 (1934).

23. See SEN. REP. No. 665, 72d Cong., 1st Sess. (1932) 40; H. R. REP. No. 708, 72d Cong., 1st Sess. (1932) 28; *Hearings Before House Committee on Ways and Means,*

on the estate tax for gift taxes paid on property included in the gross estate at death.[24] This indicates that Congress foresaw possible overlapping of the two taxes and did not intend that both should be collected on the same base value. Recognizing that the two taxes are closely related both in structure and in purpose,[25] the courts have expressed disapproval of imposing both upon the same property value.[26] Where an inter vivos transfer is deemed so incomplete that the property will properly be included in the transferor's gross estate at death,[27] no gift tax is imposed. Both taxes are assessed in the case of gifts made in contemplation of death, but gift tax payments are credited against the estate tax.[28] Insofar as the Board's decision approves assessment and collection of both taxes on the same economic value, it is thus at variance with the legislative and judicial policy of integrating the two tax statutes.

In contrast with the Board's rigid adherence to form in the principal case is the attitude adopted by the courts in applying gift tax provisions to donative transfers in trust. Trusts, like corporations, are described as "persons" in the Revenue Act.[29] The formal trust was initially regarded as the proper donee by the Board of Tax Appeals[30] and the federal courts.[31] Only one $5,000 exclusion was permitted regardless of the number of trust beneficiaries.

Revenue Revision, 72d Cong., 1st Sess. (1932) 18; 65 CONG. REC. 8095, 8096 (1924); 75 CONG. REC. 5788 (1932).

24. See note 9 *supra*.

25. See Burnet v. Guggenheim, 288 U. S. 280, 286 (1933), expressing the view that the two tax statutes are plainly *in pari materia*.

26. See Chrystie, *Death Taxes and Gift Taxes on Inter Vivos Transfers—Their Correlation* (1936) 14 TAX MAG. 716, 718; Merry, *Federal Estate and Gift Tax: Concept of a Transfer* (1940) 38 MICH. L. REV. 1032, 1041; Burnet v. Guggenheim, 288 U. S. 280, 285 (1933); Estate of Sanford v. Comm'r, 308 U. S. 39, 45 (1939); Hesslein v. Hoey, 91 F. (2d) 954, 956 (C. C. A. 2d, 1937), *cert. denied*, 302 U. S. 756 (1937); First Nat. Bank of Birmingham v. United States, 25 F. Supp. 816, 818 (N. D. Ala. 1939).

27. This was the broad test laid down in Estate of Sanford v. Comm'r, 308 U. S. 39 (1939). See Magill, *The Federal Gift Tax* (1940) 40 COL. L. REV. 773, 782, 783; (1940) 38 MICH. L. REV. 566.

28. Fish v. Helvering, 75 F. (2d) 769 (App. D. C. 1934), *aff'g* 27 B. T. A. 1002 (1933).

29. See note 11 *supra*.

30. Thomas E. Wells, 34 B.T.A. 315 (1936), *aff'd*, 88 F. (2d) 339 (C.C.A. 7th, 1937); Seymour H. Knox, 36 B.T.A. 630 (1937); Katherine S. Rheinstrom, 37 B.T.A. 308 (1938), *rev'd*, 105 F. (2d) 642 (C.C.A. 8th, 1939). The Board carried its position to a logical conclusion by holding that a donor making gifts to two trusts was entitled to two $5,000 exclusions even though the beneficiary of the two trusts was the same individual. Edwin B. Cox, 38 B.T.A. 865 (1938). Realizing the tax evasion possibilities in this result, Congress provided that the exclusion provision should not apply to gifts in trust after the year 1938. REVENUE ACT OF 1938, § 505(a), 52 STAT. 565, 26 U.S.C. § 553(b) (Supp. 1938). See SEN. REP. No. 1567, 75th Cong., 3d Sess. (1938) 41.

31. Comm'r v. Wells, 88 F. (2d) 339 (C.C.A. 7th, 1937), *aff'g*, 34 B.T.A. 315 (1936); see Comm'r v. Krebs, 90 F. (2d) 880, 881 (C.C.A. 3d, 1937); Noyes v. Hassett, 20 F. Supp. 31, 32 (D. Mass. 1937).

But this strict construction of the statute was relaxed in *Welch v. Davidson*,[32] which held that the beneficiaries of the trust were the proper donees for gift tax purposes and that a separate $5,000 exclusion should be allowed for each beneficiary. All recent federal court decisions but one have followed this view,[33] and the Board of Tax Appeals has since changed its position to conform with it.[34]

In thus disregarding formalities of trust title and probing the underlying equitable interests of the trust beneficiaries, the courts have reached a result more in accord with donative intent. It is difficult to believe that a donor making a transfer in trust intends to bestow his bounty upon the abstract trust. His purpose is to benefit the cestuis. Later cases dealing with donative transfers in trust have accorded much weight to this factor.[35] Similarly, in the case of a transfer without consideration to a family corporation, the donor does not intend his benevolence to extend to the corporate "person." The corporation is a mere conduit through which he hopes to confer his benefits upon the shareholders.[36] Disregard of formal legal title and concentration upon the intent of the donor, as in the trust cases, would therefore seem a sounder method of taxing donative transfers to family corporations.[37]

32. 102 F. (2d) 100 (C. C. A. 1st, 1939), *aff'g*, 22 F. Supp. 726 (D. Mass. 1938), 86 U. of Pa. L. Rev. 907.

33. Rheinstrom v. Comm'r, 105 F. (2d) 642 (C. C. A. 8th, 1939), *rev'g* 37 B. T. A. 308 (1938); Robertson v. Nee, 105 F. (2d) 651 (C. C. A. 8th, 1939); McBrier v. Comm'r, 108 F. (2d) 967 (C. C. A. 3d, 1939); Hutchings v. Comm'r, 111 F. (2d) 229 (C. C. A. 5th, 1940), *rev'g* 40 B. T. A. 27 (1939); Early v. Reid, 4 Prentice-Hall 1940 Fed. Tax Serv. ¶ 62826 (C. C. A. 4th, 1940); Pelzer v. United States, 31 F. Supp. 770 (Ct. Cl. 1940), *cert. granted*, (1940) 9 U. S. L. Week 3101; Wieboldt v. United States, 4 Prentice-Hall 1940 Fed. Tax Serv. ¶ 62729 (N. D. Ill. 1940). *Contra:* United States v. Ryerson, 4 Prentice-Hall Fed. Tax Serv. ¶ 62773 (C. C. A. 7th, 1940), *cert. granted*, (1940) 9 U. S. L. Week 3121.

34. Wilton Rubinstein, 41 B. T. A. No. 34, Jan. 30, 1940; Lillian S. Winterbotham, 4 Prentice-Hall 1940 Fed. Tax Serv. ¶ 64289, B. T. A. mem., Feb. 7, 1940; Lucy M. Gloss, 41 B. T. A. No. 167, May 24, 1940.

35. See Rheinstrom v. Comm'r, 105 F. (2d) 642, 647 (C. C. A. 8th, 1939); Hutchings v. Comm'r, 111 F. (2d) 229, 231 (C. C. A. 5th, 1940) (concurring opinion); Ryerson v. United States, 28 F. Supp. 265, 268 (N. D. Ill. 1939). The concept of donative intent has also been given effect in determining whether "bonus" payments by an employer to an employee are gifts or taxable compensatory income under the income tax statute. See Magill, Taxable Income (1936) 348.

36. Different considerations might arise if a transfer without consideration were made to a business corporation. In times of financial stress, one shareholder might contribute large sums to a business corporation in an effort to salvage the value of his own investment. Here the donor would not intend to confer benefits upon the other shareholders. It might be argued that the corporation should be considered the proper donee and that only one exclusion should be allowed. However, inasmuch as donative intent is wholly lacking in such a case, it would seem better to treat the contribution as an additional investment not subject to gift tax at all.

37. That this was the result intended by Congress is indicated by committee reports dealing with the gift tax. Both Senate and House reports contain the statement that "a transfer by *A* to a corporation owned by his children would constitute a gift to the children." Sen. Rep. No. 665, 72d Cong., 1st Sess. (1932) 39; H. R. Rep. No. 708,

The decision of the Board is supported by analogy in a line of income tax cases[38] which state as a general rule that corporate form must be preserved in matters of taxation. Despite this attitude of judicial precision in recognizing the corporate entity in income taxation, the rule is not inflexible. Exceptions have been cautiously admitted to square practical realities with the intent and purposes of tax legislation. The courts have been quick to cast aside formality where it has been utilized solely to effectuate a scheme of tax avoidance.[39] At the opposite extreme, substance has prevailed over form where rigid adherence to form would have resulted in the imposition of an unjust tax burden.[40]

No inflexible rule of law and no express statutory provision compels strict observance of the corporate fiction in taxing donative transfers to family corporations. Adherence to the example set by the courts in treating gifts in trust is more in accord with the purposes of gift tax legislation and gives effect to true donative intent. Ignoring the corporate entity and considering the underlying interests of the shareholders does not provide an avenue of tax avoidance. Revenue would be the same as that received where gifts are made outright to the individual shareholders. Moreover, the policy of Congress in fixing gift tax rates at a level substantially below estate tax rates[41] indicates

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72d Cong., 1st Sess. (1932) 28. The correlative proposition that a gift by a corporation to *B* would constitute a gift to *B* by the stockholders is also set out, indicating that Congress intended the tax on gifts to apply only to individuals. See U. S. Treas. Reg. 79, Art. 2.

38. The courts have refused to permit shareholders to deduct from their personal income tax returns losses incurred by controlled corporations. Dalton v. Bowers, 287 U. S. 404 (1932); Nixon v. Lucas, 42 F. (2d) 833 (C. C. A. 2d, 1930). Similarly a corporation formed to take over the assets and business of another corporation was not allowed to deduct losses of its predecessor in determining its income tax liability. New Colonial Ice Co. v. Helvering, 292 U. S. 435 (1934); *cf.* Woolford Realty Co. v. Rose, 286 U. S. 319 (1932); Planters Cotton Oil Co. v. Hopkins, 53 F. (2d) 825 (C. C. A. 5th, 1931), *aff'd*, 286 U. S. 332 (1932). In considering gain realized on a sale of property by a corporation to its sole shareholder, the corporation was deemed sufficiently distinct from its shareholder to permit assessment of the gain as taxable income. Burnet v. Commonwealth Improvement Co., 287 U. S. 415 (1932).

39. Higgins v. Smith, 308 U. S. 473 (1940); Gregory v. Helvering, 293 U. S. 465 (1935).

40. This result has been reached in two situations. Where a subsidiary corporation, wholly owned by its parent, declared a dividend from surplus which had accrued prior to the date of the income tax statute, it was held that the earnings of the subsidiary had in effect accrued to the parent and the dividend did not constitute taxable income. The two corporations were deemed substantially identical. Southern Pac. Co. v. Lowe, 247 U. S. 330 (1918); *cf.* Gulf Oil Corp. v. Lewellyn, 248 U. S. 71 (1918). Where a reorganization involved no change in capital structure, leaving the shareholders substantially the same rights and powers in the new corporation as they had in the old, the new corporation was considered a continuation of the old. Weiss v. Stearn, 265 U. S. 242 (1924). But *cf.* Marr v. United States, 268 U. S. 536 (1925); Cullinan v. Walker, 262 U. S. 134 (1923); United States v. Phellis, 257 U. S. 156 (1921); Rockefeller v. United States, 257 U. S. 176 (1921).

41. Gift tax rates were made exactly three-quarters of the estate tax rates. See MONTGOMERY, FEDERAL TAXES ON ESTATES TRUSTS AND GIFTS (1938-39 ed.) 423.

an intention to encourage distribution of estates by gift prior to death.[42] No word of discrimination is voiced against any special form of distribution. Zeal for revenue should not permit substitution of abstract legal formulae for practical realities in gift tax administration.

REFERENCE IN A WILL TO A TRUST AGREEMENT*

WHEN a will refers to some other writing, the doctrine of incorporation by reference is one of the devices by which effect may be given to the latter document. Unless both the theory and scope of incorporation are accurately defined, however, the resulting confusion may lead to unfortunate consequences. The requirements of the doctrine are that the will refer to the extrinsic document as being in existence, in terms clear enough to identify it and to show an intention to incorporate it, and, further, that the document actually be in existence at the time of the execution of the will and be ascertained in probate to be the one to which reference was made.[1] If these requirements are complied with, the extrinsic document is treated as a part of the will at the time of execution.[2]

This doctrine may be justified as an extension of the theory of integration. Since there is no requirement that each page of a will be separately executed, effect is given in cases of integration to declarations of testamentary intention written on sheets of paper that do not independently comply with the Statute of Wills, provided that such sheets are found to have been a physical part of the will at the time of execution.[3] They are validated by the signatures of the testator and the witnesses appearing on the last page of the will. If the paper containing expressions of testamentary intention was not physically a part of the will, but was referred to in compliance with the requirements of incorporation by reference, the reference is deemed to draw the paper into the will, so as to make it fictionally, although not literally, a part of the will at the time of execution, and, therefore, as operative as any writing that was then actually in the will.

42. See 75 CONG. REC. 5691 (1932).

* President and Directors of Manhattan Co. v. Janowitz *et al.*, 21 N. Y. S. (2d) 232 (App. Div., 2d Dep't 1940).

1. 1 PAGE, WILLS (2d ed. 1926) § 243; ATKINSON, WILLS (1937) §§ 142, 143; 1 SCOTT, TRUSTS (1939) § 54.1. See also OHIO GEN. CODE ANN. (Page, 1937) § 10504-4.

Reference to charitable trusts or foundations will not be avoided for indefiniteness or inaccuracies unless the meaning of the bequest is impossible to discover, since courts favor donations to charity. Vestry of St. John's Parish v. Bostwick, 8 App. D. C. 452 (1896); see Matter of Tiffany, 157 Misc. 873, 880, 881, 285 N. Y. Supp. 971, 980, 981 (Surr. Ct. 1935). See also statutory provisions in Colorado and Connecticut specifically allowing charitable gifts by reference in a will. COLO. STAT. ANN. (Michie, 1935), c. 41, §§ 184-6; CONN. GEN. STAT. (1930) § 4826.

2. 1 PAGE, WILLS, § 242; ATKINSON, WILLS (1937) § 143.

3. 1 PAGE, WILLS, § 238; ATKINSON, WILLS (1937) § 137.

Incorporation is permitted in nearly every state, as well as in England.[4] Only in Connecticut have the courts ruled flatly against the doctrine.[5] But in New York its use has been practically barred by dictum since the case of *Booth v. Baptist Church* in 1891.[6] Although the *Booth* case presented no opportunity for incorporation,[7] it has since been cited regularly as the foundation of a "rule against incorporation" in instances where the requisites for use of that theory were lacking.[8] In these cases the courts unanimously expressed the opinion that incorporation by reference was not recognized in New York; but no appellate court of that state was ever faced with a situation whose facts would normally justify application of the doctrine.[9]

The apparent rule against incorporation resulting from these cases was subsequently modified by two opinions of Judge Cardozo—*Matter of Fowles*[10] and *Matter of Rausch*.[11] Since the Fowles will offered no genuine case of

4. States other than Connecticut (see note 5, *infra*) where the status of incorporation is doubtful are New York (see pp. 343, 344, *infra*); New Jersey, compare Murray v. Lewis, 94 N. J. Eq. 681, 121 Atl. 525 (Ch. 1923) with Swetland v. Swetland, 102 N. J. Eq. 294, 140 Atl. 279 (1928); Louisiana, see Succession of Ledet, 170 La. 449, 128 So. 273 (1930); Arkansas, compare O'Leary v. Lane, 149 Ark. 393, 232 S. W. 432 (1921) with Rogers v. Agricola, 176 Ark. 287, 3 S. W. (2d) 26 (1928).

5. Hatheway v. Smith, 79 Conn. 506, 65 Atl. 1058 (1907).

6. 126 N. Y. 215, 28 N. E. 238 (1891).

7. The language in the will read: "Among my papers will be found a memorandum of the various securities . . ." Clearly the important requirement that the document referred to must be identified in the will as then in existence was lacking, and the case should not have been regarded as the occasion for rejection of incorporation by reference.

A partial explanation of the New York minority "rule against incorporation" might be that after being confronted in the *Booth* case with a will lacking the requirements for incorporation, the Court of Appeals decided that the doctrine itself was unsafe rather than simply refusing to apply it there. For other explanations of the effect of the *Booth* case, see Chaplin, *Incorporation by Reference* (1902) 2 Col. L. Rev. 148; N. Y. Law Rev. Comm., *Reports, Recommendations, and Studies* (1935) 431. On the New York law on incorporation before the *Booth* case, see Hawkins, *Incorporation of Extrinsic Documents in Wills* (1884) 29 Albany L. J. 484.

8. Matter of Acres, 128 Misc. 254, 219 N. Y. Supp. 313 (Surr. Ct. 1926) (memorandum); Matter of Bouvier, 257 App. Div. 665, 15 N. Y. S. (2d) 111 (1st Dep't 1939) (letter); Matter of Andrews, 162 N. Y. 1, 56 N. E. 529 (1900) (part of will below signature). For suggested distinctions among the various types of cases often confused with incorporation by reference, see Evans, *Incorporation by Reference, Integration, and Non-Testamentary Act* (1925) 25 Col. L. Rev. 879; Brinckerhoff, *Incorporation by Reference and Acts of Independent Significance in New Jersey and New York* (1937) 60 N. J. Law Journal 97.

9. One lower court decision flatly rejected incorporation in a situation suitable to its use. Matter of Martindale, 69 Misc. 522, 127 N. Y. Supp. 887 (Surr. Ct. 1910). *Cf.* Matter of Reins, 59 Misc. 126, 112 N. Y. Supp. 203 (Surr. Ct. 1908).

10. 222 N. Y. 222, 118 N. E. 611 (1918). See Comments (1918) 27 Yale L. J. 673, 16 Mich. L. Rev. 432; Notes (1918) 3 Corn. L. Q. 320, 31 Harv. L. Rev. 1170 (1917) 17 Col. L. Rev. 570.

11. 258 N. Y. 327, 179 N. E. 755 (1932). Comment (1933) 17 Minn. L. Rev. 527; Notes (1932) 32 Col. L. Rev. 917, 9 N. Y. U. L. Q. Rev. 507, 6 U. of Cin. L. Rev. 295.

incorporation, the decision should perhaps be justified on a different basis.[12] Nevertheless, in the *Rausch* case a dictum from the prior decision that the rule against incorporation would not be carried "to a drily logical extreme"[13] was given as principal authority for countenancing an apparently clear case of incorporation.[14]

The jurisdictions which have been hostile to the doctrine have failed to develop convincing objections to it. In New York, the *Booth* decision was based partly on *Matter of O'Neil*,[15] a case where a will drawn on a printed form was invalidated because the signatures of the testator and witnesses were not at the end of the instrument. This requirement of the wills statute,[16] it was felt, should be rigidly enforced. But since incorporation rests on the fiction that an extrinsic document becomes a part of the will, compliance with the statute is logically secured by treating the paper as placed in the will at the point of reference. The argument of the Connecticut court seems equally weak, particularly on the public policy grounds upon which it is based. In that state the court considered the will-making function a statutory privilege, and therefore one to be strictly construed against the testator.[17]

A possible justification in policy terms for the attitude of these courts — and one which is perhaps implicit in their decisions — is the danger that an informal document not attached to the will might be forged, altered, or secured by undue influence, and then presented in probate as the paper referred to. The difference between physical integration and incorporation by reference, however, is not marked, and the willingness of the great majority of the courts to sanction this extension of integration seems justifiable as a means of carrying out the intention of the testator.

The theory of incorporation by reference is necessary only when the extrinsic paper is testamentary and not independently executed in accordance with the Statute of Wills. If the extrinsic document or any other act referred to can be considered non-testamentary, the Statute of Wills by definition has

12. See Evans, *supra* note 8, at 900, pointing out that a non-testamentary act rationale should have been used. The reference in this case was *in futuro*, to "such last will and testament as my said wife shall leave . . ." 222 N. Y. 222, 228, 118 N. E. 611 (1918). The testator also attempted to give his wife a power of appointment by will, but since both died in a common disaster, it was argued that the power might have lapsed. 222 N. Y. 222, 241, 244, 118 N. E. 611, 616, 617 (1918) (separate dissents of Crane and McLaughlin, J. J.).

13. Matter of Fowles, 222 N. Y. 222, 233, 118 N. E. 611, 613 (1918).

14. The instrument referred to in the will was an irrevocable trust.

15. 91 N. Y. 516 (1883).

16. N. Y. DEC. EST. LAW § 21.

17. Hatheway v. Smith, 79 Conn. 506, 65 Atl. 1058 (1907). The reason given is historical and abstruse, based on a contrast with the law in England where, as the argument runs, the power to make a will is a common law right merely regulated by statute. The court's attitude is expressed in its conclusion that "The only intention that can be gathered from the language of Roxey Foss is an intent to dispose of her property in a manner forbidden by the statute of wills." 79 Conn. 506, 523, 65 Atl. 1058, 1064 (1907).

no application.[18] It is then unnecessary to use the doctrine of incorporation by reference, for its sole purpose is to prove compliance with that statute. Although the doctrine need not be employed in this situation, it may be a convenient theory for allowing reference, even to a non-testamentary paper. If, however, the jurisdiction does not recognize incorporation by reference, or if the facts of the case do not comply with its requirements, it is important to determine whether the writing is testamentary — provided, of course, that it was extrinsic to the will and therefore cannot be sustained on the theory of integration. If the document is testamentary, it is not properly authenticated and therefore inoperative.

If the description of the gift or of the beneficiary under a will requires completion, such completion may often, however, be justified on the theory of a non-testamentary act. Bequests of the contents of a certain box[19] or gifts by a testator to whoever should care for him in his last illness[20] or to those who should be his partners at his death[21] are regularly upheld on this basis. Similarly bequests to a testator's children with the proviso that advances made to them during his life should be charged against the legacies are allowed on the theory that the gifts are complete in the will, but subject to later modification by a non-testamentary act.[22] On the other hand, a bequest of certain articles to a friend to be distributed according to a "letter or memorandum of instructions which I shall leave addressed to her" is considered to require a testamentary act by the testator to complete the gift, and the clause is invalidated.[23]

In order to be "non-testamentary," the act or document must have an independent significance apart from the will — a primary purpose other than that of making a disposition effective only at the testator's death. The distinction between non-testamentary and testamentary acts has been analyzed in these terms: if future acts merely determine what is within a designation in the will, they are non-testamentary; but an attempt to create or alter a designation is a testamentary act.[24] Although the non-testamentary act theory has been used to allow reference to acts of the testator which will identify the bequest or beneficiary more often than to instruments specifying the terms of the gift, the doctrine is applicable to both instances.

18. The parol evidence rule raises no objection in these cases, since the direction in the will to an extrinsic document negatives the presumption that the will was intended to be the only evidence of testamentary intent.

19. Gaff v. Cornwallis, 219 Mass. 226, 106 N. E. 860 (1914); Robson v. Hamilton [1891] 2 Ch. 559.

20. Dennis v. Holsapple, 148 Ind. 297, 47 N. E. 631 (1897).

21. Stubbs v. Sargon, 3 Myl. & Cr. 507, 40 Eng. Rep. 1022 (Ch. 1838).

22. Estate of Wells, 184 Wis. 242, 199 N. W. 52 (1924); Moore's Case, 61 N. J. Eq. 616, 47 Atl. 731 (Ch. 1900). There is no trouble in allowing deductions for advances except where the reference is to such advances as shall be noted in the testator's accounts (or on a separate sheet—an even more difficult case). In this situation when the actual advances differ in amount from those noted on the paper referred to, the non-testamentary nature of the act becomes highly questionable. See Estate of Wells, *supra*, and Moore's Case, *supra*.

23. Hastings v. Bridge, 86 N. H. 172, 164 Atl. 906 (1933).

24. *Id.* at 247, 249, 164 Atl. 906, 166 Atl. 273, 274.

Confronted with a reference to a trust instrument, courts have frequently completed the will by incorporation,[25] sometimes apparently by use of the non-testamentary act theory.[26] Occasionally they have refused to give effect to the testator's intention.[27] Such a result was reached in a recent New York Appellate Division case.[28] A testator had made a revocable and amendable inter vivos trust agreement with plaintiff bank, with income to himself for life and certain provisions for his wife after his death. Twice he amended the deed. In his will, executed after the first two amendments and concurrently with a third,[29] he left the bulk of his personal property to the trustee of the inter vivos agreement, directing that it be added to the corpus of that trust and administered according to its terms. Later he amended the inter vivos trust once again. Plaintiff sued for a settlement of its accounts as trustee. The widow attacked the bequests under the trust provisions, disputing their validity as a part of the will and asserting her title under the residuary clause. Reversing the Special Term, the court sustained the widow's claim, holding that a revocable trust agreement could not be incorporated in a will by reference in New York.

The opinion in this case is expressed almost entirely in terms of incorporation by reference and of the so-called "rule against incorporation" in New York. The possibility of sustaining the reference on the theory that the trust had an "independent significance" is briefly dismissed with the statement that the reservation of power to amend the trust and the exercise of that power "eliminated all independent legal significance."[30]

If the incorporation theory is employed with an amendable trust, there may be difficulty in identifying at probate the exact instrument referred to in the will. But if the trust can be considered non-testamentary, the existence or exercise of a power to amend or revoke should not curtail the effectiveness of a reference to the instrument as it existed at the testator's death. Reference to the trust as an act of independent legal significance makes it immaterial whether the act takes place after the execution of the will, and compliance with the other requirements for incorporation, of course, becomes unnecessary. Such reasoning appears to support the decisions in cases of

25. Old Colony Trust Co. v. Cleveland, 291 Mass. 380, 196 N. E. 920 (1935); Koeninger v. Toledo Trust Co., 49 Ohio App. 490, 197 N. E. 419 (1934); Industrial Trust Co. v. Colt, 45 R. I. 334, 121 Atl. 426 (1923); Matter of Rausch, 258 N. Y. 327, 179 N. E. 755 (1918) *semble;* Estate of Willey, 128 Cal. 1, 60 Pac. 471 (1900).

26. Swetland v. Swetland, 102 N. J. Eq. 294, 140 Atl. 279 (1928) *semble.*

27. Boal v. Metropolitan Museum of Art, 298 Fed. 894 (C. C. A. 2d, 1924); Atwood v. Rhode Island Hospital Trust Co., 275 Fed. 513 (C. C. A. 1st, 1921).

28. President and Directors of Manhattan Co. v. Janowitz, 21 N. Y. S. (2d) 232 (App. Div., 2d Dep't 1940).

29. This third amendment was the subject of argument in the trial court because, though drawn up simultaneously with the will and plainly meant to be part of the trust as incorporated, it was not formally delivered to the trustee until the next day. It seems obvious that it should stand on the same footing as the first two amendments. See Hogue's Estate, 135 Pa. Super. 543, 6 A. (2d) 108 (1939).

30. President and Directors of Manhattan Co. v. Janowitz, 21 N. Y. S. (2d) 232, 237 (App. Div., 2d Dep't 1940).

a gift of the contents of a receptacle as of the date of testator's death,[31] and is also essential in order to allow validation of a clause referring to "such last will as my wife may leave."[32] It should be equally applicable to the case of a revocable and amendable trust.

Since the reason for development of the two concepts which permit reference to extrinsic documents is to give effect to the testator's intention, it is important to use the doctrine which will guarantee such a result in a particular situation. Once a trust is amended or revoked after execution of the will, it becomes impossible to implement the testator's apparent wishes under the incorporation theory. The instrument must be imported into the will as it stood at the time of execution.[33] As a result, the property passing under the will would be administered according to the terms of a trust which the testator had either altered or abolished.[34] These practical difficulties do not arise when a court employs non-testamentary act terms, because in that context the status of the document when the will is executed is irrelevant. The paper is used as it stands at the testator's death — presumably the form which he intended.

A decision such as the one in the instant case seems to overlook the social purposes behind the Statute of Wills and to underestimate the satisfactory formalities involved in the creation of an inter vivos trust. Here a trust indenture was formally executed by the deceased and delivered to the trustee.[35] The instrument, even though revocable, would be considered valid as against the argument that it was testamentary in character and, therefore, void for failure to comply with the Statute of Wills.[36] The requirement of delivery fulfilled in this case has ritual value equivalent to compliance with the Statute of Wills, and a formal trust indenture affords satisfactory and durable evidence of intent similar to that contemplated by the provisions of the Statute

31. Gaff v. Cornwallis, 219 Mass. 226, 106 N. E. 860 (1914).

32. Matter of Fowles, 222 N. Y. 222, 118 N. E. 611 (1918). See note 12 *supra*. Matter of Piffard, 111 N. Y. 410, 18 N. E. 718 (1888) reached a similar result with a clause providing distribution of the legatee's share to her named executors or trustees in case she predeceased the testator.

33. This limitation is necessarily implied from the requirement that the document be proved to be the exact one to which reference was made. See 1 PAGE, WILLS § 243.

34. The lower court in the instant case was driven by its logic to hold that the amendment made after the will did not affect the testamentary trust. President and Directors of Manhattan Co. v. Janowitz, 172 Misc. 290, 14 N. Y. S. (2d) 375 (Sup. Ct. 1939). For similar results, see Old Colony Trust Co. v. Cleveland, 291 Mass. 380, 196 N. E. 920 (1935); Koeninger v. Toledo Trust Co., 49 Ohio App. 490, 197 N. E. 419 (1934). It might be argued that in order to avoid such a result the testator could alter his will to correspond with each change in the trust agreement.

35. Brief of Defendant Emma S. Janowitz, p. 8. The amendments also were required to be formally delivered.

36. See Von Hesse v. MacKaye, 136 N. Y. 114, 32 N. E. 615 (1892); Van Cott v. Prentice, 104 N. Y. 45, 10 N. E. 257 (1887); Mersereau v. Bennet, 124 App. Div. 413, 108 N. Y. Supp. 868 (1908). In Bear v. Millikin Trust Co., 336 Ill. 366, 168 N. E. 349 (1929) a revocable, amendable trust was held non-testamentary, although the court conceded that it was intended to serve as a will. See generally Scott, *Trusts and the Statute of Wills* (1930) 43 HARV. L. REV. 521, 526, 527; Notes (1938) 118 A. L. R. 481, (1929) 73 A. L. R. 209.

of Wills which have an evidentiary objective. A transaction which complies so adequately with what seem to be the two most important purposes of the Statute of Wills should not be held invalidated by that statute.

The practical desirability of allowing reference in a will to a trust is clear. There seems to be no reason to thwart the testator who wishes to make further use of an arrangement previously worked out to his satisfaction without the risk or bother of repeating its terms verbatim. Furthermore, if a testator can dispose of his property by will so that a single trust results, administrative expenses can be reduced, and the larger fund will permit a greater diversification of investment.[37] Aside from these considerations, a holding like that in the principal case seems unfortunate, since it defeats the intention of people who happen to have used a procedure to which it is hard to find any fundamental objection.

AUTHORITY OF A CORPORATION PRESIDENT TO BIND THE CORPORATION BY VIRTUE OF HIS OFFICE*

WHEN an agency relationship is created, the principal ordinarily attempts to delimit the scope of the agency. Although this is especially true when the principal is a business corporation, the most notable exception to this line of conduct appears in the relationship of a corporation to its president. Typically there is no provision in either statutes[1] or charters[2] indicating the scope of the president's authority; the by-laws simply empower him to preside at meetings, perhaps to supervise the company's operations, and usually to perform the "functions of a president."[3] The inevitable result of this general authorization has been conflicting judicial determination of the extent of the president's authority to bind the corporation by his acts when there are no specific by-laws or resolutions of directors to qualify the ambiguous grant of power.

37. Local practice may, however, occasionally allow two identical trusts to be administered as one for investment purposes.

* Italo-Petroleum Corp. of America v. Hannigan, 14 A. (2d) 401 (Del. Sup. Ct. 1940).

1. The main exception to this lack of statutory provision was a Pennsylvania statute, Act of May 12, 1925, P. L. 615, § 12: "Any note . . . executed or entered into between any corporation organized or doing business within the Commonwealth and any other person . . . when signed by the president or vice president and secretary or treasurer of such corporation shall be held to have been properly executed for and in behalf of such corporation." Primarily designed to regularize the form of action undertaken on behalf of a corporation, this act also affected determination of the authority of such officers of a corporation acting for it. See Miller v. South Hills Lumber & Supply Co., 334 Pa. 293, 6 A. (2d) 92 (1939). The statute has, however, been repealed. Act of May 5, 1933, P. L. 289, art. XI, § 1102; P. L. 364, art. XII, § 1202; P. L. 457, No. 108, art. XIII, § 1302; Act of May 15, 1933, P. L. 624, art. XVI, § 1602. For a statutory definition of the authority of corporate officers, see GA. CODE (1933) § 22-712.

2. See GRANGE, CORPORATION LAW FOR OFFICERS AND DIRECTORS (1935) 101.

3. For a typical by-law provision see GRANGE, *op. cit. supra* note 2, at 450-451.

In a recent case,[4] the president of a corporation had issued in the corporation's name two promissory notes totaling over $50,000, and the assistant secretary had sealed them with the corporate seal. No specific authority had been given these officers to issue these particular notes, or any notes whatsoever. Suit to recover on the notes was brought against the company by an assignee of the payee, who was not, however, an innocent purchaser for value. The Supreme Court of Delaware adopted the view that *by virtue of his office* the president had prima facie authority to perform any acts within the scope of the company's business, and remanded the case for a jury determination of the scope of the business.[5] In so doing, it rejected the earlier point of view of the courts that a presumption of no liability existed until authority was proven.[6]

The doctrine that, in the absence of a specific grant of power, authority to act is conferred by the mere vesting of an office must rest upon one of two principles of agency. Either the filling of the office carries with it a real or actual authority intended by the principal to be implied from the office,[7] or else, despite a lack of such real authority, there may be an apparent authority if the principal holds the president out to third persons as president and that office connotes certain authority in the community.[8] Even when there are specific instructions to the agent not to act in a certain way, apparent authority may exist if the public is not aware of these limitations.[9]

Since both these bases for finding authority rest upon an interpretation of what the office of president means — interpretation by either the principal or by the community —, inquiry into the historical background of corporate development may give perspective. At the start of the nineteenth century there were less than two hundred private corporations in existence in the United States — due largely to popular hostility which was only then disappearing.[10] In such an atmosphere — and with corporations generally of small size — the presidential office conferred authority to do little more than preside over directors' meetings. Such a situation is illustrated by an 1815 Kentucky case which held that a hemp spinning company was not bound by a contract to buy hemp made by its president who had no specific authority so to contract.[11] Yet clearly the purchase was within the scope of the company's business. With the increasing tempo and size of corporate business during the nineteenth century, courts grew more disposed to include such acts within the scope of the president's authority. In 1850 the Pennsylvania

4. Italo-Petroleum Corp. of America v. Hannigan, 14 A. (2d) 401 (Del. Sup. Ct. 1940).

5. In two previous cases the Delaware Superior Courts took much the same approach. See Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co., 34 Del. 567, 156 Atl. 350 (1931); Atlantic Refining Co. v. Ingalls & Co., Inc., 37 Del. 503, 185 Atl. 885 (1936) (holding no liability because the action of the president was outside the usual business, but affirming the principles of inherent authority).

6. See note 24 *infra* and cases there cited.

7. Restatement, Agency (1933) § 26.

8. *Id.* § 27.

9. *Id.* § 49, comment *a*.

10. Wormser, Frankenstein Incorporated (1931) 30-31.

11. Macbean v. Irvine's Exec., 7 Ky. 17 (1815).

Supreme Court held a shipping corporation liable for a lease of offices for the company made in its name by the president who had no specific authorization so to act.[12] However, other jurisdictions were slow to accept this view. As late as 1862 a California court refused to hold a mining corporation liable on a contract of its president for purchase of properties to be used in mining operations, on the ground that the purchase was for the purpose of extending operations and hence outside the scope of ordinary business.[13]

As cases turning on presidential authority grew in number after the Civil War, it has become increasingly difficult to piece together a composite picture of the corporation's liability for the acts of its president. It is evident, however, that the tremendous growth of corporate business, both in size and in compass, in the past fifty years, coupled with emergence of dominating personalities at the head of many corporations, has resulted in an inevitable concentration of executive power in the corporate president.[14] A corollary of this has been the decline in importance, until recent legislation checked the trend, of the board of directors in the active management of corporate affairs.[15] Judicial recognition of this shift of power has resulted in most states in the sanctioning, as within the president's authority by virtue of his office,[16] of such actions as issuance and endorsement of negotiable paper,[17] borrowing funds,[18] and making short term employment contracts.[19]

12. Baltimore & P. Steamboat Co. v. McCutcheon & Collins, 13 Pa. 13 (1850). "Who, then, was the proper person to make the contract? Certainly, the president. We must bear in mind that these kind of artificial men, or persons, are becoming very common in this State. . . . They compose a new element, or ingredient, of modern society. They contract with everybody, and about all manner of things; and they can contract by their chief officers; and such is their usual course of business. The president of a company presents himself to make a contract, evidently connected with the business. He declares the object and purpose of the contract. Who doubts him? We are a dealing people. Is he asked to produce the charter and books of the company, to show that he is authorized to make the contract *secundum artem?* Such is not the custom." *Id.* at 15-16.

13. Blen v. Bear River & Auburn Water & Mining Co., 20 Cal. 602 (1862).

14. Copeland, *The Job of an Executive* (1940) 18 HARV. BUS. REV. 148. In the case of eleemosynary or charitable institutions, where no such concentration of presidential power has occurred, public policy in holding the corporation liable is the reverse of that applying to private business. The effect of the policy is to hold the corporation liable as seldom as possible and to keep the officers and agents of the corporation to strict accountability. See People's Nat. Bank v. New England Home for Deaf Mutes, 209 Mass. 48, 49, 95 N. E. 77 (1911); Jennie Clarkson Home for Children v. Missouri, Kansas & Texas Ry. Co., 182 N. Y. 47, 58, 74 N. E. 571, 574 (1905).

15. For discussions of the present condition of corporate directorates and suggestions for improvements see Bates, *The Board of Directors* (1940) 19 HARV. BUS. REV. 72; Douglas, *Directors Who Do Not Direct* (1934) 47 HARV. L. REV. 1305.

16. In this extension of corporate liability, the size of the company has apparently counted for little, although one might expect one-man corporations would be held to a stricter liability for presidential acts. For exceptions to the general practice, see Black v. Harrison Home Co., 155 Cal. 121, 99 Pac. 494 (1909); Bloom v. Nathan Vehon Co., 341 Ill. 200, 173 N. E. 270 (1930).

If a corporation should choose a dummy president, further difficulties might arise. No cases have been found in this field clearly indicating that the president was intended to

The general increase in the scope of the president's authority as it is commonly exercised in business practice has resulted in one significant procedural change. In many jurisdictions the burden of proving authority, or want thereof, has been shifted from the third person to the corporation.[20] This is important not only because the burden of proving authority was often difficult for a party not having access to the internal records of the corporation, but also because it has led to closer judicial analysis of authority, particularly of that authority resulting by virtue of office. That this change of view may have some effect upon the substantive law of what is to be included in the scope of the president's authority by virtue of his office seems possible. The Delaware court in the instant case spoke of the "reasonable and practical view" that the president be "presumed to have, by virtue of his office, certain more or less limited powers in the transaction of the usual and ordinary business of the corporation."[21] Other cases show some indication that a rule of procedure as to who shall have the burden of proof might well develop into an absolute grant of authority to the president by virtue of his office.[22]

As yet, however, even the prima facie presumption of authority has been accepted in not quite half the states.[23] Many jurisdictions, primarily those

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be a mere figurehead, but it would appear that a corporation wishing to avoid liability for the acts of such an executive would have to specifically negative the president's authority in the by-laws or, preferably, in the charter itself. Mere failure to grant him authority would probably not be sufficient to defeat the presumption of his power. See note 27 *infra*.

17. Dexter Sav. Bank v. Friend, 90 Fed. 703 (S. D. Ohio, 1898); George E. Lloyd & Co. v. Matthews, 223 Ill. 477, 79 N. E. 172 (1906). *Contra:* St. Vincent College v. Hallett, 201 Fed. 471 (C. C. A. 7th, 1912), Goodman Mfg. Co. v. Mammoth Vein Coal Co., 185 Iowa 253, 168 N. W. 912 (1918).

18. Africa v. Duluth News Tribune Co., 82 Minn. 283, 84 N. W. 1019 (1901). But this is not the general rule. See 2 FLETCHER, CYCLOPEDIA OF CORPORATIONS (perm. ed. 1931) § 602.

19. Ceeder v. H. M. Loud & Sons Lumber Co., 86 Mich. 541, 49 N. W. 575 (1891). In the following cases unusual actions of the executive have been upheld by the courts: Sun Printing & Pub. Ass'n v. Moore, 183 U. S. 642 (1902) (charter of a yacht to take reporters to scene of Spanish-American War); Marvin v. First Nat. Bank of Aurora, 10 F. Supp. 275 (N. D. Ill. 1935) (president of bank acting as trust officer); Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co., 34 Del. 567, 156 Atl. 350 (1931) (purchase of 45 miles of gas pipe). The rule seems to be that any activity, however unusual, may be held binding if it is within the realm of the corporation's business. For a list of acts outside the president's power, see 2 FLETCHER § 592.

20. See, for the older view, Martin v. Webb, 110 U. S. 7, 14 (1884). The view there expressed is given as the usual one in the treatises. See 2 FLETCHER, CORPORATIONS (perm. ed. 1931) § 557; BALLANTINE'S MANUAL OF CORPORATION LAW AND PRACTICE (1930) § 105.

21. Italo-Petroleum Corp. of America v. Hannigan, 14 A. (2d) 401, 406 (Del. Sup. Ct. 1940). See also the detailed discussion in 2 FLETCHER §§ 556 *et seq.*

22. See Sparks v. Dispatch Transfer Co., 104 Mo. 531, 15 S. W. 417 (1891); Stokes v. New Jersey Pottery Co., 46 N. J. L. 237, 240 (Sup. Ct. 1884). No other cases have been found which follow the liberal approach thus laid down.

23. Not all the states follow any clear course. Some have taken no stand on the question, while others have occupied positions on both sides. It seems likely, but not

in which corporate enterprise has been less prevalent, have clung to the older view that there is no authority in the president by virtue of his office to bind the corporation.[24] Those that do allow the presumption have generally adopted one of two views: either that there is a rebuttable presumption of authority to perform any act within the scope of the company's ordinary

certain, that the following jurisdictions would adhere to the view of inherent authority: Cal., Walker v. Kimball Fruit Co., Inc., 283 Pac. 895 (Cal. App. 1929). *Contra:* Padgham v. Inyo Marble Co., 116 Cal. App. 328, 2 P. (2d) 531 (1931); Del., Italo-Petroleum Corp. of America v. Hannigan, 14 A. (2d) 401 (Del. Sup. Ct. 1940); D. C., Newbold v. Brennan Constr. Co., 48 App. D. C. 90 (1918); Fla., Miami Jockey Club v. Lillias Piper, Inc., 115 Fla. 612, 155 So. 806 (1934); Ga., Newton v. Social Circle Cotton Mill Co., 174 Ga. 320, 162 S. E. 667 (1931) *semble;* Kan., Childress v. Lucky Jew Lead & Zinc Co., 134 Kan. 743, 8 P. (2d) 376 (1932); Ky., Ross v. Eagle Coal Co., 237 Ky. 660, 36 S. W. (2d) 48 (1931); La., Slagle v. Peyton, 182 La. 358, 162 So. 12 (1935). *Contra:* Massman v. Louisiana Mfg. Cooperage Co., 177 La. 999, 149 So. 886 (1933) *semble;* Md., Conservation Co. v. Stimpson, 136 Md. 314, 110 Atl. 495 (1920) *semble;* Mich., Melvindale State Bank v. Eckfeld, 283 Mich. 179, 277 N. W. 876 (1938). *Contra:* Jacob v. Gratiot Central Market Co., 267 Mich. 262, 255 N. W. 331 (1934); Mo., Shumake v. Basic Metals Mining Corp., 129 S. W. (2d) 36 (Mo. App. 1939); Mont., Bingham v. National Bank of Mont., 105 Mont. 159, 72 P. (2d) 90 (1937); Neb., First Trust Co. of Lincoln v. Shurtleff, 130 Neb. 476, 265 N. W. 543 (1936) *semble;* Nev., Reno Water Co. v. Leete, 17 Nev. 203, 30 Pac. 702 (1882); N. J., Iback v. Elevator Supplies Co., Inc., 118 N. J. Eq. 90, 177 Atl. 458 (Ch. 1935). *Contra:* Knopf v. Alma Park, Inc., 105 N. J. Eq. 299, 147 Atl. 590 (Ch. 1929), *aff'd,* 107 N. J. Eq. 140, 152 Atl. 919 (1930); N. Y., Schwartz v. United Merch. & Man., Inc., 72 F. (2d) 256 (C. C. A. 2d, 1934); N. C., White v. Johnson & Sons, Inc., 205 N. C. 773, 172 S. E. 370 (1934); Va., Richmond, F. & P. R. R. v. Snead & Smith, 60 Va. 354 (1869); Wis., Kline v. Little Rapids Pulp Co., 206 Wis. 464, 240 N. W. 128 (1932). See generally Klein, *Extent of the Power and Authority of the President of a Corporation to Bind it by Contracts* (1896) 42 CENT. L. J. 194 (emphasizing the extent to which the equities have controlled the result reached by the courts).

24. States most consistently holding to the older view of presidential authority are: Ala., Brush Elec. Light & Power Co. v. City Council of Montgomery, 114 Ala. 433, 21 So. 960 (1896); *cf.* Navco Hardwood Co. v. Bass, 214 Ala. 553, 108 So. 452 (1926); Ark., Dent v. People's Bank of Imboden, 118 Ark. 157, 175 S. W. 1154 (1915); Ind., State *ex rel.* Guaranty Bldg. & Loan Co. v. Wiley, 100 Ind. App. 438, 196 N. E. 153 (1935) *semble;* Iowa, Homesteaders Life Ass'n v. Salinger, 212 Iowa 251, 235 N. W. 485 (1931); Ohio, Kroeger, Sup't v. Brody, 130 Ohio St. 559, 200 N. E. 836 (1936); Okla., McMahan & Co. v. Hibbard, 182 Okla. 503, 78 P. (2d) 409 (1937) *semble;* Tenn., Nickey Bros. v. Lonsdale Mfg. Co., 149 Tenn. 391, 258 S. W. 776 (1923); Utah, Copper King Mining Co. v. Hanson, 52 Utah 605, 176 Pac. 623 (1918); Vt., Goodenough's Adm'x v. Vermont-People's Nat. Bank, 106 Vt. 5, 168 Atl. 914 (1933) *semble;* Wash., Crown Paving & Constr. Co. v. Walla Walla County, 122 Wash. 144, 210 Pac. 357 (1922); W. Va., Kelly Convert. Wagon Co. v. Rhodes Mfg. Co., 102 W. Va. 16, 135 S. E. 242 (1926). Only one of these states, Ohio, is primarily an industrial or corporation state. It should be noted that these jurisdictions have often held corporations liable for acts of the president when the equities so required; the customary ground is an implication of authority from a vague authorization. See Vincennes Savings & Loan Ass'n v. Robinson, 23 N. E. (2d) 431, 435 (Ind. App. 1939); Citizens' Bank v. Public Drug Co., 190 Iowa 983, 988, 181 N. W. 274, 277 (1921).

business[25] or, more broadly, to do anything that the directors could authorize.[26] The basis of the latter view is protection to third parties dealing with the president whenever he could conceivably be acting with authority, while the purpose of the former limitation is to protect third persons only in ordinary situations where they would be likely to expect him to be acting with authority, *i.e.*, when he is carrying on the ordinary business of the company.

The question of what is required of the corporation to rebut the prima facie case when the president has acted beyond his actual authority has not been clearly answered. In all probability a mere showing that there was no positive grant of such authority to him would not be sufficient, but the corporation would have to make some showing that the president was denied the power to do that particular sort of act.[27] However, since the presumption applies only to acts within the scope of the company's business, or to those which the directors could authorize, the plaintiff must first show that the particular deed of the president here was within this scope. Until then no presumption can arise.

As the corporate movement has now outgrown limitations founded on rudimentary corporate activity, new principles corresponding with actual corporate practice should be introduced. Thus, if in fact the president is usually the chief executive officer of a corporation, he should be recognized as such by the courts without the necessity of his authority being proven by persons who rely on it in ordinary every-day dealings with him. Furthermore, if the complexity of the business world has thrown on the president new and wider powers, these should be recognized by the courts as being within an extended scope of authority. If the approach of the principal case is generally adopted, a further step will be taken toward increased security of business transactions, which may or may not be a beneficial result. It certainly is in keeping with the trend, now over a century old, to facilitate commerce at the expense of static ownership. At the same time, since courts or juries will still be free to determine whether the president's action was sufficiently part of the corporate business to warrant the application of the principles of authority *virtute officii*, the advance can be taken with reasonable safety.

25. Various terms, practically synonymous, have been substituted for "usual course of business" by the different courts. They include "ordinary business," "routine," "general scope of the business," etc. No importance is attached to the various phrasings of the idea.

26. Adams v. Barron G. Collier, Inc., 73 F. (2d) 975 (C. C. A. 8th, 1934); Schwartz v. United Merch. & Man., Inc., 72 F. (2d) 256 (C. C. A. 2d, 1934).

27. Just how much proof is needed to rebut a prima facie case of authority by virtue of the office of presidency has not been determined in most jurisdictions. In Omaha Wool & Storage Co. v. Chicago Great W. R. R., 97 Neb. 50, 149 N. W. 55 (1914), the court indicated that the corporation must show an actual denial of authority. See also Newbold v. Brennan Constr. Co., 48 App. D. C. 90, 94 (1918). Such a view seems unnecessarily strict and might operate to curb corporate presidents sharply, if it were generally followed.